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MANAGEMENT OF THE DEPARTMENT OF DEFENSE

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BEFORE THE

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FIRST SESSION

PART 3

COST ACCOUNTING STANDARDS

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CONTENTS

Page

Opening statement of Senator Roth 1

WITNESSES

THURSDAY, MAY 19, 1983

Mary Ann Gilleece, Deputy Under Secretary for Research and Engineering, Acquisition Management, Department of Defense; Derek J. Vander Schaaf, Deputy Inspector General, Office of Inspector General, Department of Defense; Clark G. Adams, Group Director, General Procurement Subdivision, General Accounting Office, accompanied by Harry R. Van Cleve, Acting General Counsel, GAO; and William G. Onsted, president, Private Sector Council, accompanied by Charles T. Smith 5

Charles O. Starrett, Jr., CPA, Director, Defense Contract Audit Agency; Bertold Bodenheimer, CPA, vice president, McGrow, Pridgeon & Co., CPAs; and Frederick Neuman, CPA, special consultant with Peat, Marwick, Mitchell & Co., CPAs 53

ALPHABETICAL LIST OF WITNESSES

Adams, Clark G.:
- Testimony 5
- "Encouraging Capital Investment Within Cost Accounting Standard 409—Depreciation of Tangible Capital Assets," memorandum from Gen. Robert L. Herriford, Sr., February 2, 1983 24
- Prepared statement 35

Bodenheimer, Bertold:
- Testimony 53
- Prepared statement 68

Gilleece, Mary Ann:
- Testimony 5
- Prepared statement 29

Neuman, Frederick:
- Testimony 53
- Prepared statement 85

Onsted, William G.: Testimony 5

Starrett, Charles O. Jr.:
- Testimony 53
- Prepared statement 62

Vander Schaaf, Derek J.:
- Testimony 5
- Prepared statement 48

ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD

Letters from:
- Aerospace Industries Association of America, Inc 93
- Association of Government Accountants 94
- Boeing Company 95
- Department of Energy 96
- Electronic Industries Association 97
- National Aeronautics and Space Administration 101
- National Security Industrial Association 105

Letter to Caspar W. Weinberger, Secretary of Defense, from Senator William V. Roth, Jr., July 11, 1983, with enclosures ..... Page 106
"Air Force Systems Command—Profit Study 1982," summary report 111

MANAGEMENT OF THE DEPARTMENT OF DEFENSE

THURSDAY, MAY 19, 1983

U.S. SENATE,
COMMITTEE ON GOVERNMENTAL AFFAIRS,
Washington, D.C.

The committee met at 9:35 a.m. in room SD-342, Dirksen Senate Office Building, Hon. William V. Roth, Jr. (chairman of the committee) presiding.

Present: Senators Roth, Rudman, and Levin.

Chairman ROTH. The committee will please be in order.

I have a prepared statement which will be included as if read. I do want to make some extemporaneous remarks.

OPENING STATEMENT OF SENATOR ROTH

Chairman ROTH. Today the Governmental Affairs Committee will hold hearings on certain cost reimbursement and cost accounting practices and procedures used in managing Defense Department contracts. These are matters of critical importance because they literally involve tens of billions of dollars of the taxpayers' money.

Certain of these practices were adopted during times of rising inflation and interest rates. Others have been proposed as a means to improve productivity in defense industries, admittedly a worthy goal. Unffrtunately, a number of these practices appear wasteful of taxpayer money and could have the serious effect of ballooning defense costs. Let me illustrate what I mean.

The matters are complex, difficult to understand, but I think it is important that we understand not only of what we speak but their impact both on the defense budget as well as on the national deficit.

We are potentially dealing with what we estimate could equal as much as $40 billion of additional costs annually. Obviously such amounts deserve our closest attention.

The first matter involves the Defense Department's prepayment of contractors for accrued vacation pay. It is estimated that a change in the timing of payments for accrued vacation pay could amount to a first year's savings of as much as $2.5 billion.

The second matter involves progress payments. Progress payments are made regularly during the course of a contract to reimburse the contractors for their incurred costs. These payments back in 1981 were raised from an 80-percent level to as high as 100 percent. They were raised at that time presumably because it was a

period of double-digit interest rates and it was intended to help provide additional investment incentives for contractors.

The rationale for this increase in progress payments no longer appears valid, and it is estimated that by scaling them back, as much as $5.1 billion could be saved in a 1-year's savings. Annual savings in interest thereafter could run to roughly $0.4 billion.

The third factor involves interest on defense contract work. Until 1976, interest was an unallowable cost on defense contracts and had to be recovered from the fee or profits. In that year, the Government—this was not the Department of Defense, but was done through the Cost Accounting Standards Board—recognized as an allowable cost the equivalent of interest on the investment in capital facilities used in defense work. In other words, if a contractor had undepreciated facilities for which he paid $100 million, the Government would allow the equivalent of interest on that amount.

Again, various groups such as the Grace Commission task force have estimated that this is costing the Government billions of dollars annually.

The fourth matter we will be discussing today is the question of depreciation of tangible capital assets, such as equipment and buildings. Under cost accounting standard 409, depreciation costs were reimbursed on the basis of the life of the asset. As part of the Carlucci Initiatives, the Department of Defense has proposed more rapid asset depreciation to encourage capital investment to enhance productivity.

It is not exactly clear how it would be implemented, but Dr. DeLauer, the Under Secretary of Defense, Research and Engineering, has issued a memorandum encouraging the military departments to enter into advance agreements with contractors on shorter periods of depreciation.

Under the Initiative, depreciation costs based on replacement value would also be permitted. The concept, insofar as I know, has never been recongnized commercially. In other words, if a contractor paid $1 million for an asset that would cost $1.1 million to replace today, depreciation would be based on the latter figure, on the theory that that is what it would cost the contractor to maintain his facilities. The theoretical argument can be made on this proposition, especially in terms of high inflation.

But contrary to our general efforts in Government today to prevent the expansion of what I call automatic cost-of-living type of formulas to limit Government costs, we are encouraging such a formula with the Initiative. What we are dealing with here really is an automatic cost-of-living program for defense contractors. The General Accounting Office has made a study of the impact of this proposal, the Carlucci Initiative 5a, on seven major contractors. It is estimated that for these seven contractors alone, over a 5-year period, it would cost the Government an additional $2.44 billion in contract expenditures. We have something like 1,100 defense contractors. If one wanted to extrapolate—and admittedly, this is the worst case scenario, but it is one that is possible under Carlucci Initiative 5a—it has been estimated that it could cost the Government as much as $40 billion more annually in cost overruns. Whether that figure is correct or not, or even if the actual amount is lower,

say even half of it, it raises some very substantial questions as to whether the additional costs can be justified.

My concern with the DOD actions that we are reviewing today is that too little analysis has been done by DOD to determine the effects of these proposals on the budget. As far as I can determine, DOD has no idea how much these proposals will cost and has little data to suggest that they would even be effective in stimulating increased contractor investments. There are possibly billions of dollars involved. We cannot afford to let the Defense Department move ahead on these matters with a blindfold on.

Frankly, I am amazed that before adopting these policies that more careful and complete consideration has not been given to them. I am sure that DOD will claim it is studying the matters and is continuing to collect information on them. Yet the Office of Management and Budget, one of the subcommittees of the Grace Commission, the General Accounting Office, and the DOD IG are all concerned with the DOD's proposed policies, and our information is that some of the military services themselves are reluctant to implement some of these policies. I am hopeful we can shed more light on these matters today.

I welcome each and every one of our witnesses.

[Senator Roth's prepared statement follows:]

PREPARED STATEMENT OF SENATOR WILLIAM V. ROTH, JR.

Today, the Committee on Governmental Affairs continues the series of hearings on Defense Department management which began on March 23rd. The committee will examine possible problems in the implementation of two cost accounting standards and in contract payment procedures which we estimate could cost the Government tens of billions of dollars in extra outlays annually and billions more in interest costs. If our preliminary findings are borne out by this hearing and by further work being conducted by the General Accounting Office, the serious management problems we have reviewed in our previous hearings may look small by comparison.

I want to make it very clear at the outset that I am not prejudging the Defense Department's actions by calling these hearings. I do believe, however, they owe us a full explanation of how the policies we will be reviewing today will work and how much they will cost. I don't believe DOD can do that and I hope these hearings will help begin the process of carefully assessing the merits of these policies.

As I have stated in the two earlier hearings we have held on defense management, I believe we do need to improve our military capabilities. I am afraid, however, that the public is skeptical that DOD knows how the defense dollars should be spent. Indeed, recent polls show that they just do not believe that the significant increases already approved in the defense budget can be spent effectively and, most importantly, efficiently. Daily, stories appear in the press revealing new problems in defense programs. To the public, it must seem that DOD is like Al Capone: You can accuse it of any crime and it can be shown to be guilty.

I think these perceptions are unfortunate and in many cases wrong. But the fact is that the way things appear to be is the way many will see them unless strong, sustaied and intensive efforts are made to eliminate every possible inefficiency and to stop waste wherever it occurs in defense programs.

I believe we can do much more to improve the management of defense programs and that is why I have convened this series of hearings. I know DOD claims to have implemented programs which it says will save money and increase efficiencies. Just last week, I received a letter from the DOD comptroller outlining savings he says will amount to some $29 billion over the next five years.

Yet, we still hear complaints from DOD officials that they are being stymied in their efforts to improve management by unstable program funding, too many legal and procedural requirements and "too much auditing and finger pointing", as one defense official put it. I agree we need to stabilize the defense funding process and remove unnecessary regulations and requirements that bind the hands of management.

In our hearing today, we will examine proposed changes in the implementation of CAS 409 and CAS 414 which could increase outlays and costs for defense contracts by over $38 billion annually if careful consideration is not given to the policies involved. It shouldn't take a microscope to find these problems and to consider alternatives and improvements.

In addition, it appears that another seven billion dollars in outlays and over a half billion dollars in interest costs could be saved by the department through better cash management practices in its contracts. These possible losses can be avoided if DOD will carefully consider proposed policy changes and take steps to determine the full effect of future actions.

We will review the Department's efforts to implement several cost accounting standards, broad statutory guidelines which establish uniform methods of accounting for costs on negotiated contracts for weapon systems and equipment. These standards were developed by the now inactive cost accounting standards board which was established because Congress was concerned that there was no way to ensure that contractors were accounting for their costs uniformly, making it very difficult and costly to administer procurement contracts. The Congress has not funded CAS Board operations since 1980.

The standards issued by the CAS Board are now considered to be statute yet, as we will hear today, major changes which could cost billions of dollars annually are being considered by DOD in the way two of the cost accounting standards, CAS 409 and 414, are being implemented. Changes have already been made in the way contractors are being compensated for their contract costs which could also cost billions of dollars in outlays and hundreds of millions more in interest costs.

The rationale for all of these changes is to increase contractor investments in their plant and capital assets which could help decrese the costs of future contracts through increased productivity. I am second to none in my concern that the United States remains competitive in the world market and continues to have the most productive and efficient capital base possible. I firmly believe that if DOD encouraged real competition for the majority of its contracts, we would have less need for CAS standards and other policies to encourage investment in defense plants. Contractors would invest on their own because they would know there was less chance of being the low bidder on a contract unless their plants were as productive and cost efficient as possible.

Unfortunately, DOD competes less than forty percent of its contracts and as a result, artificial mechanisms, such as the cost accounting standards, are needed to account for costs in the contract negotiation process and control them during contract performance.

My concern with the DOD actions we will review today is that it appears that little if any analysis has been done by DOD to determine their effects on the budget. DOD has no idea how much these proposals will cost and it has little data to suggest that they would even be effective in stimulating increased contractor investments. With possibly billions of dollars in contract overruns involved, we cannot afford to let the defense department move ahead of these matters with a blindfold on. I am simply amazed that DOD would consider adopting these policies without giving careful and complete consideration to their ultimate effects.

I am sure that DOD will claim it has studied these matters and is continuing to collect information on them. Yet, the Office of Management and Budget, one of the subcommittees of the Grace Commission, the General Accounting Office and the DOD Inspector General are all concerned that DOD may be diving off the high board without checking to see if the pool is filled. Our information is that some of the military services are reluctant to implement some of these policies.

I hope we can shed more light on these matters today and I welcome our witnesses.

POTENTIAL FINANCIAL IMPACT OF IDENTIFIED WASTE IN FOUR DEFENSE DEPARTMENT PROCUREMENT POLICIES—WORST CASE SCENARIO

[In billions]

Nature of waste	Applicable department		Total amount
	Defense	Treasury	
Future contract cost increases due to faster writeoff of investments in capital assets:			
CAS 409—depreciation of tangible capital assets	$26.4	$2.1	$28.5
CAS 414—cost of money as an element of the cost of facilities	11.7	1.0	12.7

POTENTIAL FINANCIAL IMPACT OF IDENTIFIED WASTE IN FOUR DEFENSE DEPARTMENT PROCUREMENT POLICIES—WORST CASE SCENARIO—Continued

[In billions]

Nature of waste	Applicable department		Total amount
	Defense	Treasury	
Subtotals	38.1	3.1	41.2
Early cash outlays due to progress payment policies:			
Contractor employees accrued vacation costs	2.5	.2	2.7
Progress payment rates	5.1	.4	5.5
Subtotals	7.6	.6	8.2
Totals	45.7	3.7	49.4

Chairman ROTH. Senator Rudman?

Senator RUDMAN. I do not have an opening statement, Mr. Chairman.

Chairman ROTH. We will now begin with the witnesses. I would ask that each one of you limit your testimony to 10 minutes. Your full statement, however, will be incorporated as if read.

We are happy to have Miss Mary Ann Gilleece, who is here as Deputy Under Secretary for Research and Engineering, U.S. Department of Defense. Miss Gilleece, would you please start.

TESTIMONY OF MARY ANN GILLEECE, DEPUTY UNDER SECRETARY FOR RESEARCH AND ENGINEERING, ACQUISITION MANAGEMENT, DEPARTMENT OF DEFENSE; DEREK J. VANDER SCHAAF, DEPUTY INSPECTOR GENERAL, OFFICE OF INSPECTOR GENERAL, DEPARTMENT OF DEFENSE; CLARK G. ADAMS, GROUP DIRECTOR, GENERAL PROCUREMENT SUBDIVISION, GENERAL ACCOUNTING OFFICE, ACCOMPANIED BY HARRY R. VAN CLEVE, ACTING GENERAL COUNSEL, GAO; AND WILLIAM G. ONSTED, PRESIDENT, PRIVATE SECTOR COUNCIL, ACCOMPANIED BY CHARLES T. SMITH

Ms. GILLEECE. Thank you, Mr. Chairman.

I am pleased to have this opportunity to appear before you to present the views of the Department of Defense on the cost accounting standards.

Public Law 91-379, establishing the Cost Accounting Standards Board, was passed in 1970 as a result of congressional concern over inconsistent cost accounting principles for defense contractors and subcontractors. The Board was charged with the responsibility "of promulgating standards designed to achieve uniformity and consistency in the cost accounting principles followed by defense contractors and subcontractors." Thus, the Board was charged between 1971 and 1980 with issuing the regulations, and in point of fact promulgated 19 cost accounting standards. As you noted, these standards were based on the accrual method of accounting.

Mr. Chairman, in the textbook written by John Cibinic and Ralph Nash, renowned professors in the area of government contract law—and I know John Cibinic has recently testified before this committee—they state in their textbook, and I quote:

Two basic accounting methods are recognized under generally accepted accounting principles. The cash basis of accounting is occasionally used by businesses with relatively simple transactions while the accrual basis is used by organizations with more complex dealings. Under the cash basis, costs are recognized and recorded when cash is disbursed by the business. Under the accrual basis, costs are incurred when an obligation to pay arises and are recorded as accrued costs at that time, even though actual payment is not required until some later time. Although there is no specific prohibition against the use of the cash basis in government contract accounting, the overwhelming majority of government contractors use the accrual basis.

Mr. Chairman, this method permits relatively easy and accurate verification of payment requests against contractors' books and records without requiring additional recordkeeping by the contractors.

Any contractor who files a public financial statement must keep its records according to this method. Thus, additional cash basis records would require additional contractor personnel and expense, which would be charged to government contracts, and it would require additional government resources to validate and verify the accuracy between the two sets of books and a request for payment.

Mr. Chairman, you had occasion to mention CAS 408, cost accounting standard 408, regarding the accrual of vacation pay. The cost accounting standards were promulgated by the Cost Accounting Standards Board. The Department does follow the standards as defined by that Board.

Your suggestion that that particular standard should be revisited would clearly support our position that we need a Cost Accounting Standards Board at this particular time to examine possible modifications and waivers to cost accounting standards. While we do not agree that there is an impact monetarily at this particular time on the Department of Defense budget, as you suggest there may be, we however do support the need for the Board.

I might also suggest, sir, that regarding your discussion of CAS 409, which essentially is depreciation, and CAS 414, which is the cost of money as an element of the cost of facilities capital, the interest that you suggest is not an allowable cost on the defense contracts. There is, however, a correlation between CAS 409 and CAS 414, and I will spend a moment to explain that, if I might.

CAS 409 deals with depreciation, and recently the Dr. DeLauer memorandum indicated that the contracting officers and the people who are responsible for government contracts should specifically read CAS 409.50(E)(5) which states:

The contracting parties may agree on the estimated service life of individual tangible capital assets where the unique purpose for which the equipment was acquired or other special circumstances warrant a shorter estimated service life than the life determined in accordance with the other provisions of this paragraph 409.50(E) and where the shorter life can be reasonably predicted.

Essentially what that means, sir, is that if you buy a particular item and you are only going to use it for 6 years, then you depreciate for the 6 years and not for a longer period of time. However, if you intend to use it for 14 years, I presume you could agree to depreciate it over those 14 years.

By the same token, we discussed CAS 414, and I can tell you unequivocally that the Department of Defense has no intention whatsoever of basing the position on replacement value. Much of what

has been provided to us as far as support for the particular amounts of money that are intended to be saved by the suggestion that 414 should be revisited is based upon the fact of replacement value.

What the Department of Defense currently does is to take the Treasury rate, multiply that times the net book value of the asset. Now, the net book value of the asset is the acquisition cost minus the depreciation factor. If the depreciation is over a shorter depreciation life, then the cost of money will be less. It will clearly be a smaller amount of money because of the fact that you have depreciated the asset and one applying the Treasury rate to the net book value over a shorter period of time.

But I can tell you that the answers that we provided for the record to the questions that were provided to us for response indicated that replacement value will not be used for the determination of depreciation, nor will the accelerated cost recovery system be the basis for depreciation.

The CAS Board ceased to function in October 1980 when Congress decided to discontinue its funding. The basis for the congressional action was the understanding that the Board had promulgated all the regulations necessary.

Cost accounting standards are generally applicable to negotiated contracts over $100,000 except where the price is based on, (1) catalog or market prices of commercial items sold in substantial quantities to the general public, or (2) prices set by law or regulation. The CAS Board exempted certain categories of contracts, such as small business awards, and provided limited coverage for foreign concerns and companies with relatively small amounts of negotiated defense contracts.

DOD has a record of aggressively implementing cost accounting standards. In 1976, the CAS Steering Committee and working group were chartered. The Steering Committee provided top management surveillance over CAS implementation and established DOD policies to smoothly integrate CAS rules and regulations into defense procurement practices. The CAS working group was established to carry out the detailed work of the committee.

From 1976 through 1981, the Steering Committee issued 25 guidance papers that have provided assistance to field personnel in implementing cost accounting standards. In October 1982, the official charter of the Steering Committee and working group was allowed to expire, as the work of insuring smooth integration of CAS into our regulations had been completed. While there currently is no function for the Steering Committee, the working group has continued to meet on an ad hoc basis to discuss CAS administration issues as they are identified. There continue to be minor problems that arise from time to time, but none that would merit the attention of a high level body on the order of the former steering committee. We in OSD intend to continue to hold ad hoc working group meetings, as necessary, to insure that proper guidance is provided to field activities.

Mr. Chairman, I would like to digress once again from the statement provided to your committee and discuss the progress payment issue for just a moment.

Progress payments were amended in March 1981 to reflect the increased interest rates. In October 1981, they increased another 5 percent, at this point going from 85 to 90 percent, to reflect the fact that the Department of Defense ceased payment on a biweekly basis and began paying on a monthly basis.

The progress payments established in the defense acquisition regulations are currently at 90 percent for large businesses and 95 percent for small businesses.

I think the committee should also recognize that the progress payment provision also requires that when progress payment vouchers are provided to the Department of Defense, the Department does not pay any voucher when the contractor has already paid an amount to another contractor. In other words, it is to encourage the immediate payment of small subcontractors and other subcontractors.

I might suggest that in March 1981, as well as right now, interest rates are not what they were when the original progress payments amount had been established at 80 percent.

The Department currently supports the continuation of the 90 and 95 percent, assuming that that meets with the contractors' needs at this particular time. The progress payments are paid on fixed price contracts and they are intended as a method of financing contracts.

Mr. Chairman, in 1974, the DOD began a 2-week course of instruction on cost accounting standards at the Army Logistics Management Center. The course was designed to give contract auditors and contract administrators an in-depth knowledge of the CAS Board promulgations. ALMC developed a 1-week refresher course for individuals not requiring in-depth knowledge. The feedback from students has been very enthusiastic and we are very proud of these courses. They provide students with information that they find they can put to immediate use in their jobs.

Chairman ROTH. I would remind you that we are going to try to keep each person to 10 minutes.

Ms. GILLEECE. Yes. I understand that, Mr. Chairman. If I may just simply conclude and provide the rest of the statement for the record.

Let me just suggest that the Department would certainly be willing to examine any supporting evidence for these savings that have been mentioned by the chairman in his opening statement. But the basis upon which we have made our position apparent to the committee at this particular time I do believe is supported by a difference of opinion with some of the reports that might have been provided to the committee.

Thank you, sir.

Chairman ROTH. What we are going to do is hear from each of the witnesses before we go into the question and answer period.

I would just like to ask one question of you, Miss Gilleece. I understand that what you are now saying is that under the Carlucci Initiative 5a, where the Department proposed repealing or amending CAS 409 to permit more rapid capital equipment depreciation and recognize replacement depreciation cost, if I understand your testimony, you are saying the Department of Defense does not intend to give recognition to replacement cost and that as far as

accelerated depreciation is concerned, it would not be based on ACRS. Is that correct?

Ms. GILLEECE. Yes, sir.

Chairman ROTH. Has that been officially declared?

Ms. GILLEECE. Mr. Chairman, in the answers provided to the record, I might state in question 29(b), the response is, "The enclosed internal report dated March 7, 1983 indicates that no further action is required on Acquisition Initiative No. 5a. DOD does not intend to pursue repeal or amendment of CAS 409, nor does DOD desire to use replacement cost or the accelerated cost"——

Chairman ROTH. Just a minute. You say does not intend to repeal or amend?

Ms. GILLEECE. Or amend CAS 409, yes, sir. It does not intend to pursue repeal. We would not have the right to repeal or amend that particular standard—"nor does DOD desire to use replacement cost or the accelerated cost recovery system for determining depreciation cost."

Chairman ROTH. Are you still proposing to enter advance agreements on depreciation?

Ms. GILLEECE. Mr. Chairman, there are advance agreements formulated with the Department to determine overhead amounts prior to the year in which the contract is performed. And let me suggest that when it is appropriate, that accelerated depreciation will be considered, as required by the cost accounting standard.

Chairman ROTH. We will proceed with the other witnesses at this time.

At this time I would like to call on Mr. Clark Adams, who is accompanied by Harry Van Cleve. Mr. Adams is Group Director for the General Procurement Subdivision, U.S. General Accounting Office. Mr. Adams?

Mr. ADAMS. Good morning. Mr. Chairman and Senator Rudman, I am pleased to have this opportunity to appear before the committee on behalf of GAO to discuss issues involving cost accounting standards.

As you just mentioned, I am accompanied today by Mr. Harry Van Cleve, Acting General Counsel of the General Accounting Office. Previously Mr. Van Cleve was General Counsel of the Cost Accounting Standards Board for most of that Board's life.

I have a prepared statement to submit for the record and, with your permission, I will summarize the major points of that statement.

As you are aware, the Cost Accounting Standards Board ceased operations in September 1980. During its life, the Board had issued 19 standards covering almost all aspects of government contract cost accounting.

GAO supports efforts to revitalize the Cost Accounting Standards Board. In any continuing Board function, however, there are two elements that we consider critical.

The first is that the continuing function must be independent. The second is that it must have sufficient accounting expertise to insure that the accounting integrity of the existing standards is not disturbed. A more complete statement on our support of these efforts can be found in our report to you of May 3, 1983.

In carrying out our procurement oversight responsibility, we at GAO are conducting several reviews involving specific cost accounting standards. One review involves CAS 409 and CAS 414. This review looks at how these standards relate to one of the DOD initiatives for improving the acquisition process. You expressed interest in these two standards, and I would like to discuss briefly some results of our preliminary review.

Over 2 years ago, DOD set forth their 32 initiatives for improving the acquisition process. On October 21, 1981, Comptroller General Bowsher testified before your committee about our plan to monitor the implementation of those initiatives. At that time, he pointed out that GAO had special concerns regarding Initiative 5. The stated intent of that initiative is to encourage contractors performing under defense contracts to invest in capital facilities that will increase productivity. While we support in principle the initiative's intent of enhancing productivity, Mr. Bowsher testified that action item 5 needed further evaluation before it was implemented.

It calls for repealing or amending CAS 409 to permit more rapid capital equipment depreciation and to recognize replacement depreciation costs. Replacement cost is a common term used for inflation accounting. CAS 409 prescribes methods for allocating depreciation costs to contracts. Because of our concern with 5(a) and because DOD was unable to provide any estimates on the cost impact of its implementation, we sought to develop such information ourselves.

A House subcommittee sought our views on this initiative, and on November 17 we delivered an executive summary to that subcommittee which outlined our preliminary observations. Our preliminary study was performed at seven contractor segments, or divisions, which provided us with their actual asset acquisitions and depreciation policy data for a 5-year period, 1977 through 1981.

We put this data through six discrete hypotheses to try and cover all the elements that might be considered as being defined by the initiative. The most extreme hypothesis considered ACRS, or rapid depreciation, reinvestment, and replacement, or inflation, cost depreciation. Based on this hypothesis, which we admit is an extreme, we estimate that the added depreciation expense and related cost of money that would go to the Government could be as high as $2.4 billion. Since conditions similar to those we examined at the seven segments could exist at more than 1,000 other contractor segments, the potential impact of such a change with respect to the entire defense industry could obviously be much more than $2.4 billion.

Furthermore, this is not a one-time cost increase but, rather a continuing situation. Should this DOD initiative be implemented, similar additional costs would continue as long as contractors remain in business, purchase assets, and contract with the Federal Government.

We are not concluding that the seven contractor segments in our study are sufficiently representative to permit us to draw an industry-wide conclusion. Because of the magnitude of our findings, it was decided that we should continue our study to assess this impact under circumstances that will provide a result more nearly predictable for the entire defense industry. Under this continuing

study, we have expanded the scope of our original survey to gather the same type of data from 75 of the top 100 defense contractors. Our review on this is scheduled for completion in September of this year, 1983.

As mentioned previously, our executive summary was delivered to the House subcommittee on November 17, 1982. We had previously briefed DOD representatives on the results of this study. On December 20, 1982, DOD issued a memorandum to its procurement activities which concerns CAS 409. This memo states that DOD has reassessed CAS 409 and finds it may be administered in a manner which is consistent with improvement of contractor productivity.

In essence, this memo states that a special provision of CAS 409 provides the latitude under which DOD can enter into advance agreements with contractors on shorter depreciation periods for certain assets than would otherwise be determined by CAS 409.

We believe that this memorandum encourages DOD procuring activities to treat what is essentially an exception provision of the standard as the standard's primary focus. Because of this memo, Congressman Brooks, Chairman of the House Committee on Government Operations, in a letter to the Secretary of Defense stated that the DOD memo has the practical effect of repealing CAS 409.

In his response to Congressman Brooks, the Secretary of Defense said that earlier reimbursement of depreciation costs under abnormally short lives would be offset by decreases in the cost of money reimbursed under CAS 414. The point being made is that use of abnormally short lives does not cost any more than would otherwise be allowable. We do not concur with DOD's conclusion because it fails to take into consideration the reinvestment that would likely occur.

CAS 409 was carefully drafted by the Cost Accounting Standards Board. It was founded on the cost accounting concept that depreciation costs "should be a reasonable measure of the expiration of service potential of the tangible assets subject to depreciation." It was published twice in the Federal Register for comment, and during its promulgation hearings were held in both the House and the Senate. Congress concurred with the standards as promulgated. We are opposed at this time to any action that would abandon expiration of service potential as a basic principle for measuring depreciation in favor of an arbitrary measure which has been devised for other than cost accounting purposes. We believe that DOD should not proceed with Initiative 5(a) and further that the DOD memorandum of December 20 should be rewritten, withdrawn or modified to correct what GAO believes is focusing undue attention and emphasis on what is essentially an exception provision of the standard.

To suggest that CAS 409 be amended to provide increased cash flow and return on investment as an incentive to invest in capital assets defeats the essential purpose of the standard. CAS 409 should not become the vehicle for stimulating cash flow and ROI, regardless of the purpose for which such stimulation is desired.

Chairman Staats, speaking for the Board at the Senate hearings on CAS 409, identified DOD profit policy as the place to influence contractor investment. We agree with that position and believe using the standard to provide these investment incentives would

disguise as an element of cost what is properly an element of profit.

In the course of our review of Initiative 5a, we made concomitant observations on the impact of the cost of money provided under CAS 414. CAS 414 establishes criteria for the measurement and allocation of the cost of capital committed to facilities as an element of contract cost. Using actual depreciation data from the seven contractors we visited, not including replacement costs because replacement cost was not a factor in this, using the actual depreciation data from the seven contractor segments in our preliminary study, we calculated $511 million as the amount reimbursed to these segments under CAS 414.

One additional point that surfaced during our preliminary study has raised questions concerning the extent to which CAS 409 has required contractors to adopt longer asset lives.

During the Senate hearings on CAS 409, 10 witnesses gave testimony and 30 additional statements were submitted for the record. Many witnesses from industry expressed reservations about CAS 409's promulgation, noting that CAS 409 would cause asset lives to be lengthened unreasonably, thus negatively affecting contractor cash flow.

In our survey of the seven contractor segments, six segments indicated to us that they had not changed their asset lives as a result of CAS 409's promulgation. In our continuing industry-wide review, we have specifically requested contractors to identify changes in asset service lives that have occurred subsequent to CAS 409 so that we can speak more directly to this question.

CAS 409 and 414 and DOD profit policy are all interrelated. We believe that no amendment to CAS 409 should be attempted until a combined effect of these factors is thoroughly evaluated.

Mr. Chairman, that concludes my statement. I will be glad to answer questions.

Chairman ROTH. Thank you, Mr. Adams.

At this time I will call on Derek Vander Schaaf, Deputy Inspector General from the Office of the Inspector General.

Mr. VANDER SCHAAF. Thank you, Mr. Chairman.

In my prepared remarks I did not address CAS 409 and CAS 414 because the Inspector General's Office has not had an opportunity to audit or study those areas since we were created. However, I do cover CAS 408, which, of course, deals with accrued personal absences and the progress payment policies in the Department, within my prepared statement.

Since my statement is relatively short, Mr. Chairman, I would like to read it and then be available for any questions.

We in the Inspector General community agree with the use of accrual accounting for compensated personal absences and strongly endorse these cost accounting principles. However, we are concerned about the timing of reimbursements to contractors for such accrued costs. We are especially concerned when the contractor accrues the costs but doesn't pay them until much later.

To illustrate, consider accrued vacation costs, the major category of compensated personal absence costs. It often takes 18 months between the initial accrual of vacation costs and the contractors's actual payment for them. No one, to my knowledge, has analytical-

ly quantified the amounts of accrued vacation costs, but we estimate that it approaches $2 billion annually. With large accrued vacation costs and the current high rates of progress payments under fixed price contracts, it is possible that current progress payments to contractors could exceed their actual outlays of cash. This would also be true for cost-type contracts. If this is true, the Government could be providing some contractors with interest-free loans. The U.S. Treasury would be paying significant interest costs for what are in effect cash advances.

In June 1982, I proposed to the Under Secretary of Defense for Research and Engineering that he consider limiting contract payments for vacation expense to the amounts actually paid by contractors. My proposal was similar to current DOD practices for certain other accrued costs.

For example, DOD contract clauses preclude reimbursement to contractors for accrued pension costs until the contractor has paid into a pension fund. Also, under the standard progress payment clause, DOD contractors can only receive payments from the Government after they pay for items purchased from subcontractors.

In responding, the Under Secretary of Defense for Research and Engineering did not think that changing reimbursement practices for accrued vacation was warranted or practical. He stated that the flexible progress payment concept considered contractor float for all accrued expenses in determining the amount of progress payments. The correspondence on this matter between my office and other DOD organizations has been made available at your request and provides additional information on this issue.

The objective of the flexible progress payment procedures is to tailor more closely the payment rate to the cash needs of a contractor for a particular contract. The flexible payment rate is determined through the use of a DOD cash flow computer model referred to as cash II. The use of flexible progress payment procedures is optional for fixed price type contracts. We are concerned that this system of progress payments is now being widely used without any follow-up studies or audits to ascertain the accuracy of the flexible progress payment model.

I might add at this point, which is not in my statement, I have recently learned there was something less than uniform agreement within the Department when the adoption of the flexible progress payment DAR provision was agreed to or was implemented.

Computer models are notorious for the ways they can be gamed to produce a desired outcome. Here we are dealing with a computer model. In addition, my office is unaware of any audit that has been done of an entire contract being administered under flexible progress payments to determine what was the real cash flow situation as opposed to the cash flow predicted by the model. Thus, there has been no independent verification of this system of flexible progress payments.

Our concerns on the reimbursement of accrued vacation expenses would be abated, if not eliminated, if current progress payment rates were lowered to where they were a few years ago, 80 percent for a large business and 85 percent for a small business. I recognize that during the recent period of rapid inflation and high interest rates DOD tried to ease the financial burden of contractors

22-859 O - 83 - 2

by increasing the progress payment rates. Interest rates as high as we recently experienced have only happened once in the last century.

Chairman ROTH. I am going to interrupt for just a moment. I will have to recess this hearing for about 5 minutes so another committee can get started. The committee is in recess.

[Brief recess.]

Chairman ROTH. The committee will please be in order.

I apologize, Mr. Vander Schaaf, but unfortunately, the Finance Committee had to have seven members to start their proceedings.

Mr. VANDER SCHAAF. I worked up here on the Hill for about 10 years, Mr. Chairman. I understand the situation.

Chairman ROTH. Please proceed.

Mr. VANDER SCHAAF. When I left off, I was emphasizing the fact that in implementing the flexible progress payment provisions of the DAR, there was not unanimous agreement within the Department by any means that this flexible progress payment was either required or that it would necessarily result in an accurate or an appropriate progress payment. It was instituted anyhow in the summer of 1981.

As I stated before we broke, we are concerned that neither that computer model which supports the flexible progress payment provision of the DAR has not been audited, nor have we taken any contracts which are under the flexible progress payment and looked at the real cash flow as opposed to the cash flow that was predicted by the computer model.

Well, to finish up, and I was just about done, I mentioned our concerns on this accrued vacation matter would go away in relatively short order if we would go back to an 80 percent progress payment because then there would be enough gap to insure that we were not in fact providing more cash than the contractor required to perform under that contract and take care of his work in process.

Interest rates as high as we have recently experienced have only happened once in the last century. With a decrease in inflation and interest rates closer to historical levels, I believe that progress payment rates should be returned to the standard 80 percent rate. We also should fund or implement the creation of a new Cost Accounting Standards Board.

With that, I will complete my statement and be available for your questions. Thank you.

Chairman ROTH. Thank you, Mr. Vander Schaaf.

We also have here with us today Mr. William G. Onsted, who is a member of the President's Private Sector Council. It is my understanding Mr. Onsted has no prepared statement but is here to answer questions.

Mr. ONSTED. That is correct.

Chairman ROTH. Mr. Onsted, the Task Force on Financial Asset Management, which was a part of the President's Private Sector Survey on Cost Control, recommended that the DOD progress payment rates be lowered to 80 percent for large businesses and 85 percent for small businesses. I believe the task force proposed 90 for large and 95 for small business.

Would you please summarize the task force findings on this matter?

Mr. ONSTED. Yes.

Mr. Chairman, I would like to preface my answer to that question by stating my affiliation first. I am William Onsted, president of the Private Sector Council. This is a nonprofit organization founded by individuals who were principals of the Financial Asset Management Task Force of the President's Private Sector Survey on Cost Control. We founded this organization to assist the Government in the task of implementing our task force recommendations.

We are no longer directly affiliated with the PPSSCC and are not speaking at this meeting under their auspices or authority.

Now, in review of our findings, our findings indicated that in the summer of 1980, DOD was approached by a group of defense contractors on the basis of a need for relief for economic conditions they were currently working under. A summary of those economic conditions was an extremely high inflation rate, in the 14-percent range, and an average interest rate that ranged from 14 to 20 percent.

Following that approach, memoranda were issued through the DOD in order to encourage a response to the DOD contractors' problem.

The first response that we were able to observe was one in March 1981, and that response was to give an interim increase of 5 percent in order to adjust for the severe inflationary and interest problems the contractors were under.

Also at that time there was discussion of moving to a flexible progress payment approach which would be ready by the summer of 1981.

In the summer of 1981, the flexible progress payment approach was enacted and, in addition, another 5-percent increase in the customary progress payment rates was enacted, in October, in order to offset the portended change from 2 weeks to once a month in progress payment billing cycles.

Our findings indicate that since the March 1981 recommendation of an additional 5 percent, inflation rates have come down and interest rates have come down and the need for that interim increase no longer exists.

In addition, our findings also show that many contractors were billing the government on a 30-day cycle because of their accounting cutoff methods. So the impact of going from 2 weeks to 30 days is not clear as to whether or not it justifies a full 5-percent change in progress payment funding. Intuitively, it would seem more in the area of 2 percent would be relative.

Therefore, based on these findings, we recommended that customary progress payments be rolled back to 80 percent for non-small business and 85 percent for small business.

We further are concerned about the flexible progress payment issue because of the DOD policy of implementing that system under a 5-percent work in process use of working capital on the part of the contractor, which would be tantamount to a 95-percent progress payment range.

We are also concerned about the float issue which was talked about by Mr. Vander Schaaf, and in this particular case the pre-

liminary report we got from DOD indicates that even under the 80-percent progress payment range, contractors' work in process working capital only ranged between 10 and 20 percent and that the excess use of float brought about by accrued accounting methods for use in progress payments was actually benefiting the contractors above the stated policy of an 80-percent customary progress payment.

With all of these things in toto, it does not seem reasonable to continue with the 90- to 95-percent progress payments.

Chairman ROTH. Are you in a position to estimate the financial implications to the Government if the Defense Department does not act on these recommendations?

Mr. ONSTED. We are in a better position of estimating that cost with a greater degree of accuracy now than we were at the time we wrote the report. At the time we wrote the report, we did not have access to much of the information from DOD that we have had since we have issued our recommendation. We now feel that a more accurate estimate, rather than $15 billion over 3 years, would be somewhere in the range of $6 to $9 billion.

We are currently working with DOD in order to hone in on the right, accurate estimate.

Chairman ROTH. You estimate $6 to $9 billion?

Mr. ONSTED. Over 3 years.

Chairman ROTH. Over 3 years?

Mr. ONSTED. Yes.

Chairman ROTH. That is still big chips, isn't it?

Mr. ONSTED. Absolutely.

Chairman ROTH. Is there any evidence that any of the DOD components or officials objected to this change of policy on progress payments?

Mr. ONSTED. We interviewed the Comptroller and financial groups in the Army, Air Force, and Navy, and we also looked at DCAA. Of those groups, Air Force, Navy and DCAA indicated to us that they were not in favor of the higher rates of progress payments.

Chairman ROTH. Has this practice been adopted by other branches of the Government?

Mr. ONSTED. No. This is strictly a DOD phenomenon. Under the FPR, Federal Procurement Regulations, for non-DOD, they are still using 80 percent customary progress payments. They don't have CAS 414 either.

Chairman ROTH. I just think it might be well to put in the record the statement by the task force on this matter.

So as to operate the business with a shortage of working capital, the contractor normally would borrow such funds and offset the borrowing cost, which is interest, with the created profit, thus reducing the profit margin. The government has provided the funds by increased progress payment rates and allowed no reduction to the contractor's profit margin. Again, only the Department of Defense of the government has adopted the regulation to make progress payments at the high percentage rates while the balance of the government has remained stable on its point of view of financing the private sector.

Miss Gilleece, are you aware of any DOD studies or analyses of the cost or benefits of raising progress payment rates?

Ms. GILLEECE. Mr. Chairman, Mr. Vander Schaaf suggested that there should be an audit on the flexible progress payment issue. That was put into being in October 1981, and we would support that very shortly there should be an audit done of this particular phenomenon. At this point there has not been any.

Chairman ROTH. Part of the rationale for increasing these payments was, of course, that interest rates were so high and the contractors needed to receive more money with each payment to compensate for the increased cost of their investments in facilities. Now the prime rate is at 10.5 percent, which is a drop of over 50 percent. If progress payments should go up when interest rates go up, why shouldn't they drop when interest rates come down?

Ms. GILLEECE. Mr. Chairman, as indicated in one of the answers to the questions provided to us for response, interest rates essentially are at approximately the same rate now as they were in March 1981 when we increased the progress payment amount from 80 to 85 percent.

Chairman ROTH. When did we get those answers, Miss Gilleece?

Ms. GILLEECE. Last week, sir, I am informed.

Chairman ROTH. My staff says we got them yesterday. But please proceed. We will blame it on the post office.

Ms. GILLEECE. Mr. Chairman, I am informed they were signed last Thursday.

Chairman ROTH. Of course, the question is when they were delivered here. But that is all right. Please proceed.

Ms. GILLEECE. In final response, sir, let me suggest that while interest rates have declined during the last year, if they continue to decline—and, of course, we would presume that President Reagan will continue on toward that effort and toward his success that he has had so far in lowering the interest rates—if President Reagan, continuing in that effort, will provide us a lower interest rate so that we are at 5 or 6 percent, at that time I think the Department should seriously consider the impact of that on the progress payments.

Chairman ROTH. Are you aware that OMB is very concerned with DOD's action in raising progress payment rates because of the cost involved?

Ms. GILLEECE. I am aware that OMB has examined the matter, and I am also aware, sir, that so far they have supported our payment of progress payments as currently being paid.

Chairman ROTH. It is my understanding they have asked for DOD to make a study and it is supposed to be in by the end of May.

I have a long series of questions, but I don't want to take too long at this time.

Senator RUDMAN. I have no questions of this panel at all.

Ms. GILLEECE. Mr. Chairman, if I might answer your last question, it is my understanding that we have had an ongoing dialog with OMB, as I indicated to you before, and that they have requested us to do a survey of the progress payments, which is due by the end of May.

I am also aware, by the way, that within Mr. Vander Schaaf's organization there is also an examination of the progress payment situation. The Department, however, still contends that its support-

ing the progress payment mode is more important than any increases to contract costs.

You see, if we decrease the progress payment method, it is our contention that we will still be in a position to have to pay out the same amount of money because we will find our contract price is increasing.

Chairman ROTH. Well, those are generalities, but I would like to see some facts and data. Frankly, I am very concerned about the lack of concern on the part of the Department of Defense on cost.

I am impressed with the testimony of these other organizations. I am impressed with the fact that the task force has come up with recommendations that in my judgment are highly critical of what the Defense Department is doing in these areas.

Let me go to Mr. Vander Schaaf, if I may. The Department of Defense IG recommended deferring reimbursements for accrued vacation costs as a means of reducing DOD cost outlays. Now, in the earlier testimony of the Pentagon, they partly justified that on grounds that that was accrual accounting. What is the opinion of the IG in this area now?

Mr. VANDER SCHAAF. Certainly that is justified on the accrual accounting basis, Mr. Chairman, but there are two other major factors where accrual accounting, if you applied it very strictly, would also have an effect. In both cases the Department has dealt with those in the 1970s and changed them.

As I indicated in my statement, we had a situation where a contractor could bill the Government for the retirement cost of his employees. He would then not make or fail to make a payment to his retirement fund and the Government would provide the cash.

That was changed as a result of a contract dispute case that I believe was brought before the Armed Services Board of Contract Appeals. I am not sure if it was an Armed Services Board of Contract Appeals or a Court of Claims case.

As another example, until 1971 we paid progress payments based upon accruals that occurred for products delivered by subcontractors to prime contractors. When the goods arrived in the prime contractor's plant, he accrued an obligation and the Government paid. Now the Government doesn't pay this until the contractor not only writes a check but he shows that that check is in the mail to the subcontractor. Then we go ahead and make the cash payment.

So we have two out of the three major areas where you have the highest dollar potential accruals and two of those have been corrected by DAR provisions. The proposal we made to the Office of Under Secretary for Research and Engineering would address this third one, namely accrued absences.

Now, I don't claim that it is all that important to address the third one if the overall rate of progress payments is reduced back to 80 percent. Then the problem would probably go away. But when we are paying at 90 and 95 percent, as someone else testified today, there is the possibility that we are in fact providing contractors with a cash float.

Chairman ROTH. I am not sure I agree with your conclusion, but I do agree that the cumulative effect of these various proposals is very favorable, very favorable to the contractor. When you take the

progress payments and you take the prepayment of vacation pay, when you are talking about accelerated depreciation, which I think has some merit from the standpoint of insuring modern facilities, when you take all of these things and put them together, this gives a very favorable cash flow to the contractor at the expense of the Government, isn't that correct?

Mr. VANDER SCHAAF. It could have that effect, sir. My personal position would be that you cannot deal with these CAS provisions one at a time. We ought to have a cost accounting standards board to deal with them uniformly.

For example, the CAS 409 provision impacts 414 which impacts profit policy and other things. To try to deal with just one individually is a difficult if not impossible situation.

Chairman ROTH. Due to the sizable potential reductions in cash outlays that can be realized by reducing progress payments, I wonder what the IG intends to do about that?

Mr. VANDER SCHAAF. Well, would you repeat the question? I am a little concerned; I didn't hear the first part of it.

Chairman ROTH. Let me put it another way. In view of the preliminary assessment that the present progress payment rates are too high, do you intend to have DOD IG auditors conduct any audits to fully evaluate this condition?

Mr. VANDER SCHAAF. Yes, sir; absolutely. We are in the process of forming up a new organization within our audit side of the house that will have approximately 168 people who have been trained in contract and acquisition audit. A good portion of those people will be devoted to looking at such things as progress payments and issues that cut across the whole acquisition policy area.

Chairman ROTH. Mr. Adams, from prior GAO reports and your current study, would you please summarize your preliminary findings concerning increasing contract costs resulting from CAS 414?

Mr. ADAMS. In the course of our review of Initiative 5a, we made, as I mentioned, simultaneous observations regarding the cost of money provided under 414. As we previously discussed, 414 is the standard that provides for the measurement and allocation of cost of capital committed to facilities as an element of contract cost.

Using actual depreciation data we calculated $511 million has been generated at these seven contractor segments. We were, frankly, surprised——

Chairman ROTH. Would you say that again? There are seven contractors and how much additional cost?

Mr. ADAMS. $511 million.

Chairman ROTH. Over what period of time?

Mr. ADAMS. Over 5 five years worth of assets, depreciated over the life of those assets. But the amount of money generated by 414 for those 5 years worth of assets would be $511 million.

In the calculations that we used, we used the cost of money rate of 14.75 percent, which was the cost of money rate at the time we made our study.

Incidentally, that cost of money rate has varied from 7.75 percent, which it was at the time when the standard first went into effect, to as high as 15.5 percent in the 6-month period from July 1 through December 1982. That rate has dropped dramatically, down to 11.25 percent. I assume when we complete our study of the top

100 contractors, when we use this lower rate, we will have a more modified figure. Nonetheless, the figures still generated a surprisingly high number for us.

When 414 was promulgated, DOD, through the profit 76 study, restructured its profit policy in the attempt to recognize the fact that cost of money for capital investment would now be an element of contract cost. Previously this cost had been considered as covered by profit awarded under the contract. The revision to profit policy was an attempt to ensure that this cost element would not be recovered as a cost and also in profit.

Based on its profit 76 study, DOD restructured the guidelines to reduce the profit objective by a factor it believed to be representative of the imputed interest, which would now be recognized as a cost.

In our March 8, 1979 report, GAO considered that the profit policy was written in such a way that there was insufficient offset to cover the added cost made available to contractors.

Chairman ROTH. Let me make sure I understand what you are saying. Because of the recognition of cost of capital or imputed interest, whatever you want to call it, there was supposed to be a reduction in the profit——

Mr. ADAMS. Yes.

Chairman ROTH [continuing]. Because heretofore, and I think the Grace task force has pointed this out too, commercially that cost has to be absorbed in your profit. But what you are saying, if I understand you, is you don't see the profit figure going down even though the cost of capital is being recognized. Am I correct in that?

Mr. ADAMS. In the report that GAO issued, we recognized that there was the restructuring of the profit policy to attempt to balance off on a contract average basis this increased cost by a decrease in profit. The GAO study concluded that the reduction had not been sufficient to make a full offset.

Chairman ROTH. What kind of money are we talking about here again?

Mr. ADAMS. Well, I could only speak to the amount that we generated from the data we had actually in hand, which was $511 million for those seven.

Chairman ROTH. That involved seven contractors?

Mr. ADAMS. Seven segments.

Chairman ROTH. But if you took defense contracting in general, if there is any accuracy in those figures, you are literally talking about billions of dollars, is that correct?

Mr. ADAMS. Being generated by 414, yes, I believe that is correct. I must say at this point that I believe that DOD's approach is the correct approach in terms of trying to offset for cost of money by changing the profit policy. My point is one of degree as to whether or not they had gone far enough in offsetting those added costs.

Chairman ROTH. Let me ask once again. Recognizing your study of the impact of CAS 409 and 414 on Government contractor locations is incomplete, have you seen any indications that contractors' profits as well as costs are higher as a result of CAS 414?

Mr. ADAMS. Well, I could only say that we concluded, the General Accounting Office in its 1979 report concluded that there had been a less than adequate offset. We concluded that average con-

tractor profits did increase. Since that GAO report and profit 76, there have been other increases. The range of profit, which is attributable to the facilities capital, has been increased from a range of 6 to 10 percent to a range of 16 to 20 percent.

We cannot conclude anything definite from that. However, it would be an indication that there has been an increase in the average contractor profits even further.

Chairman ROTH. Now, Miss Gilleece, when the Defense Department implemented the CAS 414 cost of money policies, were the profit levels decreased to compensate for the increased cost paid out under CAS 414?

Ms. GILLEECE. At the time, Mr. Chairman, the way the guidelines were established, there were offset impacts included within the guidelines to deal with the offsets of the 414.

I might add that I believe the study that Mr. Adams refers to deals with the entire base of a particular plant or facility or profit center, not just those allocable to a Government contract. Also, Mr. Adams' study did not use the contractors' actual figures for net book value but constructed a hypothetical situation. He then applied an interest rate of 14.75 percent, despite the fact that the actual interest rates were known and were close to half that rate for part of the 5 years. Furthermore, I think we should deal with the situation, as I suggested to you before, which is the net book value of assets as opposed to replacement cost. I might quote from a letter of April 13, 1983, signed by Caspar Weinberger, specifically stating that:

> The GAO figures are based on replacement costs, the IRS accelerated cost recovery system and full replacement of assets in the five-year period. We have already informally advised GAO that these assumptions do not reflect DOD's implementation of CAS 409.

I might also suggest that the Comptroller General, Mr. Staats, who was chairman of the CAS Board, wrote to Senator Cranston on June 27, 1975, and he specifically stated:

> With respect to service life estimates, you clearly understand the Board's intention to encourage realistic estimates of the period of economic usefulness, considering not only prior experience but also any relevant factors which can be expected to influence the service life being estimated in ways not reflected in the actual experience which is used as the baseline for estimating.

Chairman ROTH. Miss Gilleece, you have indicated that it is not DOD's intent to use replacement cost accounting, and I assume that is correct. But I would like to get some clarification of Dr. DeLauer's memorandum of December 20, 1982, in which he encourages capital investment within Cost Accounting Standard 409.

As part of that letter, or memorandum, he says that such agreements support DOD acquisition improvement program Initiative No. 5, encouraging capital investment to enhance productivity.

Has that memorandum been clarified as to what the intent is with respect to both replacement as well as accelerated cost recovery?

Ms. GILLEECE. Mr. Chairman, that acquisition initiative is broader in scope than simply the replacement cost issue.

Chairman ROTH. I am limiting my question to that one aspect.

Ms. GILLEECE. I am sorry?

Chairman ROTH. I am asking you would it still be proper under that memorandum to give recognition to replacement or to accelerated cost depreciation?

Ms. GILLEECE. No, sir.

Chairman ROTH. Has that been clarified in writing?

Ms. GILLEECE. We will provide a full answer for the record for you, sir.

Chairman ROTH. No. I am not interested so much in a clarifying to us but rather to the services themselves.

Ms. GILLEECE. Mr. Chairman, I am informed that CAS 409 absolutely does not allow what you are suggesting.

Chairman ROTH. I am just reading from this memorandum that says such agreements support DOD acquisition improvement program Initiative No. 5, encouraging capital investment to enhance productivity. Part of Initiative No. 5 was that replacement cost accounting and conceivably accelerated depreciation would be allowed. All I am asking you is has this been clarified to the military services themselves, that in entering this kind of agreement they cannot consider replacement cost and they cannot consider accelerated depreciation?

Ms. GILLEECE. Yes, Mr. Chairman.

Chairman ROTH. That has been clarified in writing to the services?

Ms. GILLEECE. Yes, Mr. Chairman.

Chairman ROTH. We would like to have a copy of that.

Ms. GILLEECE. We will provide it to you.

[The information follows:]

The enclosed memorandum dated December 20, 1982, states that CAS 409 may be administered in a manner consistent without need to improve contractor productivity. Replacement cost and ACRS are not compatible with CAS 409. Since the memo stresses encouraging capital investment within CAS 409, replacement cost and ACRS cannot be considered.

MEMORANDUM FOR THE SECRETARIES OF THE MILITARY DEPARTMENTS, DIRECTOR, DEFENSE CONTRACT AUDIT AGENCY, DIRECTOR, DEFENSE LOGISTICS AGENCY

Subject: Encouraging Capital Investment within Cost Accounting Standard 409—Depreciation of Tangible Capital Assets

Encouraging contractor capital investment to enhance productivity is of vital importance to DoD, and policies that further that goal must be actively pursued. Cost Accounting Standard (CAS) 409 has been widely criticized as being counter to DoD policies which promote increased contractor productivity. We have reassessed CAS 409 and find that it may be administered in a manner which is consistent with our need to improve contractor productivity.

The Standard provides the latitude under CAS 409.50(e)(5) to enter into advance agreements with contractors on shorter depreciation periods for certain assets than would otherwise be determined by application of the standard. These shorter periods may be based on expected useful economic or technical lives. This allows the depreciation period for qualifying assets to match more closely their expected periods of usefulness and thereby reduce contractors' investment risk. Such agreements support DoD Acquisition Improvement Program Initiative Number 5, "Encouraging Capital Investment to Enhance Productivity."

All DoD components are encouraged to pursue the advance agreement flexibility within CAS 409, along with other programs now being implemented to provide incentives for industrial modernization.

Ms. GILLEECE. Mr. Chairman, I also would mention that that paragraph specifically discusses the advance agreement with contractors on shorter depreciation periods for certain assets. As I suggested to you before, when I quoted that particular section, that does allow for an agreement, albeit in advance, for the service life of

individual tangible capital assets where there is indeed a shorter life which can be reasonably predicted.

Chairman ROTH. Mr. Adams, would you care to make any comment on that?

Mr. ADAMS. The comment I would make would be to reemphasize something I said earlier, that to use 409 to provide increased cash flow or return on investment in essence defeats the essential purpose of the standard. We think it should not become a vehicle for stimulating cash flow and return on investment, regardless of the purpose for which that stimulation is desired. We believe that to use that standard to provide these investment incentives would disguise as an element of cost what is properly an element of profit.

I would also say that the issuance of a memorandum from what is essentially the top procurement person in DOD to all agencies on one specific element of a standard focuses far more attention on that particular element of the standard than is warranted. It provides emphasis to the point where I think it seriously inbalances the standard in the eyes of the users of that standard in the field.

There were a number of DOD working group guidelines on other CAS issues which had been issued previously and where thoughtful accounting considerations had been made. The thoughtful accounting considerations that had gone into just such previous pronouncements was in my estimation seriously lacking in this memo. I believe the DOD memorandum constitutes a danger to the implementation of that standard.

Chairman ROTH. Mr. Vander Schaaf, would you comment?

Mr. VANDER SCHAAF. Well, in view of Ms. Gilleece's testimony this morning, I am not sure we have a problem to the extent we had one at first. I think in the end it will boil down to how Dr. DeLauer's memo is viewed out in the field and how in fact it is finally implemented. I believe the jury is still out on that, Mr. Chairman.

Chairman ROTH. I think it is going to be very important for your organization to followup on this matter.

Mr. VANDER SCHAAF. Yes, sir. We will have to look at that, obviously, and see to what extent they really do have a special situation when they apply special depreciation rules.

Chairman ROTH. Have you seen the Army memorandum issued to implement the DeLauer memorandum?

Mr. VANDER SCHAAF. No, I have not, sir.

Chairman ROTH. Mr. Adams, have you seen that memorandum?

Mr. ADAMS. Yes, I have. The Army picked up what I will refer to as the DeLauer memo and in my estimation accelerated it some in a memo dated February 2, 1983.

Chairman ROTH. What does it provide, Mr. Adams?

Mr. ADAMS. Shall I read the entire memo? It says:

> The attached memorandum endorses a broader use of cost accounting standard 409, depreciation of tangible capital assets, than was previously commonly made. This letter and the attached memorandum should be given wide distribution to promote the use of advance agreements with contractors on the depreciation of capital tangible assets. In order that the agreements can have a positive effect on contractors' investment decisions, agreement is encouraged to be as far in advance of acquisition of the assets as possible.

There are four additional paragraphs. Do you wish me to read those?

Chairman ROTH. Does it contain any guidelines as to what should be negotiated?

Mr. ADAMS. None that I can see here. I am sorry; I am reading such a bad copy, sir, that I can't make out the words.

Chairman ROTH. I would ask that a copy of that memorandum be submitted as part of the record.

[The memorandum follows:]

Subject: Encouraging Capital Investment Within Cost Accounting Standard 409—Depreciation of Tangible Capital Assets.

1. The attached memorandum endorses a broader use of Cost Accounting Standard (CAS) 409, Depreciation of Tangible Capital Assets, than was previously commonly made. This letter and the attached memorandum should be given wide distribution to promote the use of advance agreements with contractors on the depreciation of capital tangible assets. In order that the agreements can have a positive effect on contractors' investment decisions, agreement is encouraged to be as far in advance of acquisition of the assets as possible.

2. Because CAS 409.50(e)(5) does not require the Government to enter agreements with contractors but rather allows it, the agreements should be made only where there is an apparent benefit to the Government such as expected cost reductions or quality increases.

3. The shorter depreciation period for an asset may be based on either the estimated program life of the item(s) to which the asset will be primarily dedicated or the probable period of usefulness considering the time at which the assets function will cease or be substantially performed by other improved assets. If the depreciation period is based on the length of a program, there should be some assurance that the asset will not be used after completion of the program. If it is based on the date of probable replacement of the asset, such replacement does not demand disposal of the asset but rather allows a standby condition.

4. Agreements of this type should be considered along with other inducements for contractor investment in facilities when designing acquisition strategies.

5. Point of Contact is Harry Hindman, DRCPP-SC, AUTOVON 284-8055.

ROBERT L. HERRIFORD, Sr.,
Major General, USA,
Director of Procurement and Production.

Chairman ROTH. Mr. Onsted, many of the policies we are discussing today could have the effect of increasing contractor profits. Did you discover any studies in DOD examining contractor profit rates? If you did, what did these studies say about profit rates?

Mr. ONSTED. The study that we were able to finally obtain was obtained since our recommendation was submitted. Recently, in the last week, I reviewed a summary report of Profit Study 82 performed by the Air Force Systems Command. In that an attempt was made to try to redo the study within the Air Force Systems Command that led to CAS 414 and 76-3 and 76-23, which were modifications to the Profit 76 Study.

Using a 5-year average of 1977 through 1981, the Air Force Systems Command report indicates that negotiated profits went up 20 percent from the 1977 through 1974 similar period of time, before Profit 76. It also concludes that there was no impact on increased facilities capital purchases due to this increase in profit. In other words, 76-3 did not buy for the Government what they thought they were getting, which was an incentive for the contractors to revitalize their industrial capacity and recapitalize.

Chairman ROTH. This was a finding by the Air Force?

Mr. ONSTED. By the Air Force. It does not include the total DOD. It is strictly based on the 1499 data base of the Air Force Systems Command.

Chairman ROTH. I would ask that a copy of that be submitted for the record.

Mr. ONSTED. OK.[1]

[1] See p. 111.

Chairman ROTH. Senator Levin?

Senator LEVIN. Thank you, Mr. Chairman.

Going back to this question of accelerated or useful life depreciation, I gather that the GAO produced for you some document of the Army indicating that they interpret DOD policy to permit accelerated depreciation in negotiating costs or prices with contractors. Is that the upshot of it, Mr. Adams?

Mr. ADAMS. Yes, sir.

Senator LEVIN. I wonder if Secretary Gilleece is familiar with that document.

Ms. GILLEECE. I have it before me, sir.

Senator LEVIN. But not before today?

Ms. GILLEECE. It has been part of the answers that were provided to the committee prior to today.

Senator LEVIN. Has the Army correctly interpreted the DOD policy on this?

Ms. GILLEECE. Senator, there was an April 17, 1977 memorandum. There is now a February 2, 1983 memorandum. We certainly support the language in both of those.

Senator LEVIN. Is the Army correct in believing that they can use other than useful life depreciation?

Ms. GILLEECE. CAS 409.50(E)(5) does not require the Government to enter agreements with contractors; rather, allows it. The agreement should be made only where there is an apparent benefit to the Government, such as expected cost reductions or quality increases.

Senator LEVIN. Is the Army correct in believing that they can use anything other than useful life depreciation in negotiating contracts?

Ms. GILLEECE. The Army is correct that it can, when appropriate, as defined by CAS standard 409, utilize the appropriate method when appropriate. [Laughter.]

Senator LEVIN. I think you left out an appropriate. [Laughter.]

Ms. GILLEECE. At least we are not revisiting the 30 days again.

Senator LEVIN. Is accelerated depreciation appropriate at times?

Ms. GILLEECE. Yes, sir.

Senator LEVIN. So the Army is not incorrect in stating it can use accelerated depreciation at times?

Ms. GILLEECE. That is correct.

Senator LEVIN. Does the GAO agree with that?

Mr. ADAMS. The GAO does agree, yes, that the provision of the standard does permit the use of advance agreements.

Senator LEVIN. Are advance agreements and accelerated depreciation synonymous?

Mr. ADAMS. Well, it can be, if indeed the parties have made an advance agreement for use of accelerated depreciation and are satisfied that their action has overall benefits to the Government. They have the power under that particular provision of the standard to make such advance agreements.

Senator LEVIN. You are using accelerated depreciation and advance agreements as the same word, synonymously?

Mr. ADAMS. Well, no. I have a question as to what you mean by accelerated depreciation? If you mean the accelerated Cost Recovery System (ACRS) provided for in ERTA, or the Economic Recovery Tax Act, of 1981 as being accelerated depreciation, the answer is no. ACRS would not be permitted under the standard. If howev-

er, you just mean simply faster depreciation than would be normally allowed by CAS 409 by the term accelerated depreciation, then my answer is yes.

Senator LEVIN. Faster than useful life.

Mr. ADAMS. Yes. The standard permits advance agreements to such provisions.

Senator LEVIN. The only way they could do that is if there was a benefit for the Government or savings for the Government; is that right?

Mr. ADAMS. Yes.

Senator LEVIN. In other words, you don't necessarily see a conflict between that document which you couldn't read and the DOD policy?

Mr. ADAMS. Yes, I do. My conflict can be explained by a brief discription of CAS 409. The standard took several years to draft. It is a document that covers many pages and many provisions. The standard doesn't need nor did it intend to have any single focus on one of its elements so dramatically employed. So my argument is not ever that 50(E)(5) does not exist in the standard. I clearly know that it does. My quarrel is with the emphasis being placed on it by the top procurement executive of the DOD, saying to all of the people out there who are working this problem use this element of the standard to accomplish an economic end.

Senator LEVIN. And the elements of the standard that you are referring to is what?

Mr. ADAMS. 50(E)(5).

Senator LEVIN. How would you describe the element of the standard that is being given overemphasis?

Mr. ADAMS. The standard is made up of several parts.

Senator LEVIN. But the element that you believe is being given overemphasis by the Army. Would you describe that in words for me?

Mr. ADAMS. Yes, I will. It is in the technique for application provision of the standard, and the complete reference would be 409.50(E)(5). That is the provision of the standard. That is one small provision of a fairly lengthy standard.

Senator LEVIN. What does it provide? Just in ordinary words, without reading it.

Mr. ADAMS. It recognizes that you should work through the entire standard and determine through the criteria that are set forth what are the appropriate useful lives to be assigned to the assets to be depreciated. It goes on to provide that in the event there are unique circumstances that just don't pertain, the standard does not want not to tie the parties hands into a totally rigid rule.

Senator LEVIN. It provides for some flexibility in exceptional or unique circumstances. The emphasis on that you believe makes it the rule rather than the exception.

Mr. ADAMS. Yes, sir. The emphasis on the exception provision makes it the rule rather than the exception.

Senator LEVIN. Is that what it comes down to in a nutshell?

Mr. ADAMS. Exactly.

Senator LEVIN. Would the DOD agree with that?

Ms. GILLEECE. Senator, I would suggest we would agree with the interpretation but not the emphasis.

Senator LEVIN. You would not agree it has been overemphasized?

Ms. GILLEECE. No, sir.

Senator LEVIN. And as a result of the emphasis, the Army has now treated this as a rule rather than an exception?

Ms. GILLEECE. No, sir. There is no evidence of that.

Senator LEVIN. Can you make it clear in a new directive to the Army that it should be treated as an exception, not a general rule, since the GAO believes it has been treated by the Army as a general rule, not an exception?

Ms. GILLEECE. Senator, I could only state——

Senator LEVIN. It would be appropriate. [Laughter.]

Ms. GILLEECE. I can only state the Department of Defense has the support at least of Dr. DeLauer in the interpretation of that particular section. The Army, however, has written to its commands. I will suggest to you that the Department would very often like to be in the position to control the services more than it does. However, in this particular instance, I would suggest that the Department would totally support General Herriford's memorandum. I do believe that the memorandum accurately reflects the standard.

Senator LEVIN. Were you referring to General Herriford's memorandum in your comment about the Army, Mr. Adams?

Mr. ADAMS. You say did I or will I?

Senator LEVIN. Is that what you are referring to?

Mr. ADAMS. Yes, it is.

Senator LEVIN. You believe that memorandum does not accurately reflect the standards; is that correct?

Mr. ADAMS. I believe this memorandum merely exacerbates what I believe was an unfortunate emphasis placed on one element of the standard.

Senator LEVIN. Given the GAO's assessment of General Herriford's, memo do you stand on your belief, Madam Secretary, that the memo should not have any followup statement from the Army or the DOD saying it is not intended to give undue emphasis to the exception, and the exception should be just that? You are going to stand right where you are?

Ms. GILLEECE. That is correct, Senator.

Senator LEVIN. Thank you, Mr. Chairman.

Chairman ROTH. I see we also have Mr. Smith here. Would you like to introduce Mr. Smith?

Mr. ONSTED. Thank you, Mr. Chairman. The gentleman to my right is Mr. Charles T. Smith. He was the individual that worked with us and did most of the initial work on our recommendation on progress payments.

Chairman ROTH. I think this pretty much concludes the questions we have at this time.

Before concluding with this panel I would like to thank each and every one of you. I would say to you, Miss Gilleece, that I at least for one, am not satisfied with the kind of data and information the Pentagon is securing before it is commencing some of these new policies. We may be interested, at a later date, in further hearings on these matters. We are not talking about peanuts. I mean, what-

ever conclusions you may draw, we are talking about billions of dollars in additional costs at the very time the country, the Congress, and Government is deeply concerned about deficits.

I agree that it is important to provide incentives to defense contractors to do something about productivity, to be as modern as possible. But it is a little strange when someone looks at a number of these things being done by the Department of Defense and they are not being done in other segments of the Government. After all, other contractors who are working with the Government have some of the same expenses, the same high interest rates.

So I would say to the IG in particular, with your new independence, we will be watching very carefully as to the role your organization plays, because you, hopefully, together with GAO, are going to be the watchdog.

I would say to all of you, and particularly you, Mr. Onsted, we will be interested in your further studies and conclusions. Undoubtedly we will have further hearings. Thank you very much.

Ms. GILLEECE. Thank you, Mr. Chairman.

[The prepared statements of Ms. Gilleece, Mr. Adams, and Mr. Vander Schaaf follow:]

PREPARED STATEMENT OF MARY ANN GILLEECE

GOOD AFTERNOON MR. CHAIRMAN AND MEMBERS OF THE COMMITTEE. AM PLEASED TO HAVE THIS OPPORTUNITY TO APPEAR BEFORE YOU TO PRESENT VIEWS OF THE DEPARTMENT OF DEFENSE ON COST ACCOUNTING STANDARDS (CAS).

PUBLIC LAW 91-379, ESTABLISHING THE COST ACCOUNTING STANDARDS BOARD, WAS PASSED IN 1970 AS A RESULT OF CONGRESSIONAL CONCERN OVER INCONSISTENT COST ACCOUNTING PRINCIPLES FOR DEFENSE CONTRACTORS AND SUBCONTRACTORS. BETWEEN 1971 AND 1980, THE CAS BOARD ISSUED ITS REGULATIONS AND 19 COST ACCOUNTING STANDARDS, ALL OF WHICH HAVE BEEN ADOPTED BY DOD. THE BOARD CEASED TO FUNCTION IN OCTOBER, 1980, WHEN CONGRESS DECIDED TO DISCONTINUE ITS FUNDING.

COST ACCOUNTING STANDARDS ARE GENERALLY APPLICABLE TO NEGOTIATED CONTRACTS OVER $100,000 EXCEPT WHERE THE PRICE IS BASED ON: (1) ESTABLISHED CATALOG OR MARKET PRICES OF COMMERCIAL ITEMS SOLD IN SUBSTANTIAL QUANTITIES TO THE GENERAL PUBLIC, OR (2) PRICES SET BY LAW OR REGULATION. THE CAS BOARD EXEMPTED CERTAIN CATEGORIES OF CONTRACTS, SUCH AS SMALL BUSINESS AWARDS, AND PROVIDED LIMITED COVERAGE FOR FOREIGN CONCERNS AND COMPANIES

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WITH RELATIVELY SMALL AMOUNTS OF NEGOTIATED DEFENSE CONTRACTS.

DOD HAS A RECORD OF AGGRESSIVELY IMPLEMENTING COST ACCOUNTING STANDARDS. IN 1976, THE COST ACCOUNTING STANDARDS STEERING COMMITTEE AND WORKING GROUP WERE CHARTERED. THE STEERING COMMITTEE PROVIDED TOP MANAGEMENT SURVEILLANCE OVER CAS IMPLEMENTATION AND ESTABLISHED DOD POLICIES TO SMOOTHLY INTEGRATE CAS RULES AND REGULATIONS INTO DEFENSE PROCUREMENT PRACTICES. THE CAS WORKING GROUP WAS ESTABLISHED TO CARRY OUT THE DETAILED WORK OF THE COMMITTEE. FROM 1976 THROUGH 1981, THE STEERING COMMITTEE ISSUED 25 GUIDANCE PAPERS THAT HAVE PROVIDED ASSISTANCE TO FIELD PERSONNEL IN IMPLEMENTING COST ACCOUNTING STANDARDS. I HAVE BROUGHT A COMPLETE COPY OF THE GUIDANCE PAPERS FOR THE COMMITTEE. IN OCTOBER, 1982, THE OFFICIAL CHARTER OF THE STEERING COMMITTEE AND WORKING GROUP (DODI 5126.45) WAS ALLOWED TO EXPIRE, AS THE WORK OF ENSURING SMOOTH INTEGRATION OF CAS INTO OUR REGULATIONS HAD BEEN COMPLETED FOLLOWING THE DEMISE OF THE CAS BOARD. WHILE THERE CURRENTLY IS NO FUNCTION FOR THE STEERING COMMITTEE, THE WORKING GROUP HAS CONTINUED TO MEET ON AN AD HOC

BASIS TO DISCUSS CAS ADMINISTRATION ISSUES AS THEY ARE IDENTIFIED. THERE CONTINUE TO BE MINOR PROBLEMS THAT ARISE FROM TIME TO TIME, BUT NONE THAT WOULD MERIT THE ATTENTION OF A HIGH LEVEL BODY ON THE ORDER OF THE FORMER STEERING COMMITTEE. WE IN OSD INTEND TO CONTINUE TO HOLD AD HOC WORKING GROUP MEETINGS, AS NECESSARY, TO ENSURE THAT PROPER GUIDANCE IS PROVIDED TO FIELD ACTIVITIES.

IN 1974, DOD BEGAN A TWO-WEEK COURSE OF INSTRUCTION ON COST ACCOUNTING STANDARDS AT THE ARMY LOGISTICS MANAGEMENT CENTER (ALMC). THE COURSE WAS DESIGNED TO GIVE CONTRACT AUDITORS AND CONTRACT ADMINISTRATORS AN IN DEPTH KNOWLEDGE OF THE CAS BOARD PROMULGATIONS. ALMC DEVELOPED A ONE-WEEK REFRESHER COURSE FOR INDIVIDUALS NOT REQUIRING IN DEPTH KNOWLEDGE. THE FEEDBACK FROM STUDENTS HAS BEEN VERY ENTHUSIASTIC AND WE ARE VERY PROUD OF THESE COURSES. THEY PROVIDE STUDENTS WITH INFORMATION THAT THEY FIND THEY CAN PUT TO IMMEDIATE USE IN THEIR JOBS. THESE COURSES ARE STILL BEING OFFERED AND ARE PART OF THE REGULAR ALMC CURRICULUM. IN THE PAST NINE YEARS, OVER 2700 STUDENTS HAVE

ATTENDED THESE COURSES. THERE IS A CONTINUING NEED FOR THIS TRAINING AND DOD INTENDS TO CONTINUE TO OFFER THE COURSES.

COST ACCOUNTING STANDARDS HAVE BEEN FULLY INCORPORATED INTO THE DEFENSE ACQUISITION REGULATIONS (DAR). WITH EACH CAS BOARD PROMULGATION, THE DAR WAS REVIEWED TO DETERMINE IF CHANGES WERE NEEDED TO ENSURE CONSISTENCY WITH CAS. OUR GOAL HAS BEEN TO INCORPORATE THE CONCEPTS OF CAS INTO THE DAR AND ELIMINATE ANY CONFLICTS.

DESPITE THE PROLIFERATION OF LANGUAGE IN THE CAS PROMULGATIONS, THE DAR, AND OUR GUIDANCE PAPERS, DISAGREEMENTS HAVE ARISEN WITH OUR CONTRACTORS OVER THE PROPER INTERPRETATION OF CAS RULES, REGULATIONS, AND STANDARDS. THESE DISAGREEMENTS ARE RESOLVED THROUGH THE CONTRACT DISPUTES PROCESS. AS A RESULT, IMPORTANT COST ACCOUNTING PRINCIPLES ARE RULED ON BY THE ARMED SERVICES BOARD OF CONTRACT APPEALS (ASBCA) AND THE FEDERAL COURT SYSTEM.

THE EFFECTIVENESS OF DOD'S ADMINISTRATION OF COST ACCOUNTING STANDARDS HAS BEEN REVIEWED SEVERAL TIMES IN THE PAST BY THE

GENERAL ACCOUNTING OFFICE (GAO). IN ITS 1977 REPORT, THE GAO REVIEWED CAS NONCOMPLIANCE CASES AND FOUND THAT THEY WERE GENERALLY SETTLED IN A TIMELY MANNER. IN MARCH 1982, THE GAO REVIEWED DOD, DOE, AND NASA ADMINISTRATION OF CAS AND REPORTED THAT, IN GENERAL, COST ACCOUNTING STANDARDS WERE BEING EFFECTIVELY IMPLEMENTED.

SOME OF THE CONCERNS EXPRESSED IN THE COMMITTEE'S PRE-HEARING QUESTIONS APPEAR TO BE RESULTING FROM THE REQUIREMENTS OF THE CAS BOARD'S STANDARDS RATHER THAN FROM DOD'S IMPLEMENTATION OF THE STANDARDS. WE BELIEVE OUR RESPONSES TO THOSE QUESTIONS DEMONSTRATE THAT OUR IMPLEMENTATION OF THE STANDARDS HAS BEEN PROPER. I REQUEST THAT THE COMMITTEE'S QUESTIONS AND THE DOD RESPONSES BE INCLUDED IN THE RECORD. IF THERE ARE PROBLEMS WITH THE STANDARDS, THE COMMITEE MUST UNDERSTAND THAT DOD HAS NO AUTHORITY TO DEVIATE FROM OR CHANGE THE CAS BOARD'S PROMULGATIONS. SINCE THE CAS BOARD CEASED TO EXIST IN OCTOBER 1980, THERE HAS BEEN NO GOVERNMENTAL BODY WITH THE ABILITY TO AMEND OR ISSUE NEW STANDARDS, OR GRANT WAIVERS AND EXEMPTIONS.

NO GOVERNMENTAL REGULATIONS THAT COVER THE LEVEL OF DETAIL OF CAS SHOULD BE CHISELED INTO STONE AND LEFT FOREVER. NOR SHOULD THE ASSUMPTION BE MADE THAT THERE WILL NEVER BE A LEGITIMATE SITUATION WHERE THE REGULATIONS SHOULD NOT APPLY. BEFORE IT WENT OUT OF BUSINESS, THE CAS BOARD HAD INITIATED A PROJECT TO IDENTIFY AREAS IN THE STANDARDS, RULES, AND REGULATIONS THAT NEEDED TO BE "CLEANED UP." SOME PROBLEM AREAS ARE QUITE OBVIOUS, SUCH AS THE 7 PERCENT LIMITATION ON INTEREST THAT THE GOVERNMENT MAY CHARGE FOR CONTRACTORS' NONCOMPLIANCES. OTHER PROBLEMS ARE MORE SUBTLE. BUT IT IS CLEAR THAT THERE IS A NEED FOR A PROFESSIONAL STAFF TO BE ESTABLISHED WITH THE AUTHORITY TO UPDATE AND ADMINISTER THE CAS BOARD PROMULGATIONS. IN VIEW OF THIS NEED, I STRONGLY URGE THE COMMITTEE TO CONSIDER LEGISLATION TO ESTABLISH A CAS FUNCTION WITHIN THE EXECUTIVE BRANCH TO MAINTAIN, INTERPRET AND ADMINISTER THE CAS BOARD'S STANDARDS, RULES, AND REGULATIONS.

THIS COMPLETES MY STATEMENT. I WILL BE HAPPY TO ANSWER ANY QUESTIONS THE COMMITTEE MAY HAVE.

STATEMENT OF

CLARK G. ADAMS, GROUP DIRECTOR

Mr. Chairman And Members of the Committee:

I am pleased to have this opportunity to appear before the Committee on behalf of the General Accounting Office to discuss (1) a brief history of the Cost Accounting Standards (CAS), (2) issues involving Cost Accounting Standards 409 and 414, and (3) the desirability of reestablishing a CAS Board function.

HISTORY OF THE COST ACCOUNTING STANDARDS

In the 1960's a growing concern was expressed about differing cost accounting practices being followed under defense contracts. House Report 1455 dated May 23, 1968, observed that the absence of Standards for defense contract cost accounting was adversely affecting Government procurements. On the basis of hearings held in 1970, the Congress, in a bill extending and amending the Defense Production Act of 1950, included a new section (section 719 of that act) creating the Cost Accounting Standards Board as an agent of the Congress and independent of the executive department. The amendment was passed by the Congress and approved by the President as Public Law 91-379 on August 15, 1970. From 1970 to September 30, 1980, when it became inactive, the Board promulgated 19 Standards covering cost accounting matters.

In the several months prior to the Board becoming inactive and, for several months after, there were discussions about the need for continuing the Board function. Efforts to continue the Board failed and it ceased operations at the close of fiscal year 1980.

Concerned that the absence of an active Board function could have a negative impact on the Standards and their implementation and administration, then Comptroller General, Elmer B. Staats sent a letter to the heads of affected procurement agencies on October 3, 1980, alerting them to the fact that while the Board was not active, the Standards promulgated by the Board continue to have the full force and effect of law. Copies of the letter also were sent to appropriate members of Congress. To assure that the Board files would be preserved, GAO assumed custody of such files until such time as the function was reactivated. Additionally, a CAS monitoring group was established in the General Accounting Office to carry out its oversight role in this important procurement area.

ISSUES SURROUNDING CAS 409 AND 414

In carrying out GAO's procurement oversight responsibility, GAO is conducting several active reviews involving specific Cost Accounting Standards. One review involves CAS 409, "Depreciation of Tangible Capital Assets" and CAS 414, "Cost of Money as an Element of the Cost of Facilities Capital" as they relate to one of the DOD initiatives for improving the acquisition process. You expressed interest in these two Standards and I would like to discuss briefly some results of our preliminary review.

Over 2 years ago, in April 1981, the DOD set forth a series of 32 initiatives for improving the acquisition process. On October 21, 1981, the Comptroller General testified before your Committee about our plan to monitor the implementation of those initiatives. At that time, he pointed out that GAO had special concerns regarding Initiative 5. The stated intent of Initiative 5 is to encourage contractors performing under defense contracts to invest in capital

facilities that will enhance productivity. The Initiative listed 8 action items which were designed to encourage contractor investment in productivity enhancing capital assets. While we support, in principle, the Initiative's intent of enhancing productivity, there was one action item which we believed needed further evaluation before it was implemented.

Action Item 5a, calls for repealing or amending CAS 409 to permit more rapid capital equipment depreciation and to recognize replacement depreciation costs. CAS 409 prescribes methods for allocating depreciation costs to contracts. Because of the concern we had with this action item and because DOD was unable to provide any estimates as to what the cost impact of such an action might be, we sought to develop such information ourselves. The Subcommittee on Economic Stabilization of the House Committee on Banking, Finance and Urban Affairs sought GAO's views on this Initiative and on November 17, 1982, we delivered an Executive Summary to that subcommittee which outlined our preliminary observations on that DOD Initiative. Our survey was performed at 7 contractor segments which provided us with their actual asset acquisition and depreciation data for their five most recent years. This information gave us a mixture of real asset acquisitions by different contractors. We obtained from the contractors the value of asset acquisitions by category or class (machinery, buildings, etc.) for the years 1977 through 1981. They also provided their depreciation policies in use during those years.

We ran our data through 6 discrete hypothesis to develop a range of estimates on the possible impact of implementing Initiative 5a. The extreme hypothesis considered rapid depreciation (ACRS),

reinvestment, and replacement (inflation) cost depreciation. Based on this hypothesis, we estimate that the added cost to the Government could be as high as $2.4 billion.

Since conditions similar to those we examined at the 7 segments could exist at more than 1000 other defense contractor segments, the potential impact of such a change to the entire defense industry could be much more than $2.4 billion. Furthermore, this is not a one-time cost increase but rather a continuing situation. Should this DOD Initiative be implemented, similar additional costs could continue as long as contractors remain in business, purchase capital assets, and contract with the Federal Government.

We did not conclude that the 7 contractor segments in our study were representative enough to draw an industry-wide conclusion. Because of the magnitude of our findings, it was decided that we should continue our study to assess Initiative 5a's impact under circumstances that will provide a result more nearly predictable for the entire defense industry. Under this continuing study we have expanded the scope of our original survey to gather the same type of data from 75 contractors listed as being in the 100 companies receiving the largest dollar volume of DOD prime contracts. Completion of this review is scheduled for September 1983.

Our Executive Summary was submitted to the Subcommittee on Economic Stabilization of the House Committee on Banking, Finance and Urban Affairs on November 17, 1982. On December 20, 1982, DOD issued a memorandum for all the Secretaries of the military departments; the Director, Defense Contractor Audit Agency;and the Director, Defense Logistics Agency. The subject of the memorandum was: Encouraging

Capital Investment within Cost Accounting Standard 409 - Depreciation of Tangible Capital Assets. The memo stated in part "..... We have reassessed CAS 409 and find that it may be administered in a manner which is consistent with our need to improve contractor productivity....." In essence, this memo states that a special provision of CAS 409 provides latitude under which DOD can enter into advance agreements with contractors on shorter depreciation periods for certain assets than would otherwise be determined by application of the Standard.

This memorandum encourages DOD procuring activities to treat what is essentially an exception provision of the Standard as the Standard's prime focus. Because of this memo, the Chairman of the House Committee on Government Operations in a February 11, 1983, letter to the Secretary of Defense stated that the memo has the practical effect of repealing CAS 409. The Chairman stated that such a change could have serious budget implications and that DOD should provide any studies on the cost and resulting benefits of "advance agreements".

In his response to the Chairman, the Secretary of Defense said that earlier reimbursement of depreciation costs under abnormally short lives would be offset by decreases in the cost of facilities capital. The point being made is that use of abnormally short lives does not cost any more than would otherwise be allowable. We do not concur with DOD's conclusion because it does not go far enough. If the availability of abnormally short lives provides the incentive to invest once, it must be concluded that the continued availability will provide the same incentive again. Since this opportunity to reinvest occurs during the balance of the otherwise normal asset life, we

believe DOD should have taken into account subsequent reinvestments. When this is done, significant increased costs must be recognized. For example, one hypothesis of our preliminary study assumed short depreciation lives and reinvestment by contractors when a depreciation cycle was completed. Based on our preliminary survey the full implementation of this hypothesis could result in significant increased cost to the Government.

We believe that DOD should not proceed with Initiative 5a. We believe further that DOD's memorandum of December 20, 1982, should be withdrawn or modified to correct what GAO believes is focusing undue attention and emphasis on what is essentially an exception provision of the Standard. CAS 409 which was promulgated on July 1, 1975, was written to provide criteria and guidance for assigning costs of tangible capital assets to cost accounting periods and to cost objectives within such periods in an objective and consistent manner. CAS 409 was carefully crafted by the Cost Accounting Standards Board. It was founded in the cost accounting concept that depreciation costs "should be a reasonable measure of the expiration of service potential of the tangible assets subject to depreciation." It was published twice in the Federal Register for comment and during its promulgation hearings were held in both the House and the Senate. Congress concurred with the Standard as promulgated.

To suggest that CAS 409 be amended to provide increased cash flow and Return on Investment (ROI) as a incentive to invest in capital assets defeats, we believe, the essential purpose of the Standard. CAS 409 should not become the vehicle for stimulating cashflow and ROI regardless of the purpose for which such stimulation is desired. Mr. Staats, speaking for the Board at the Senate Hearings on CAS 409

identified DOD profit policy as the place to influence contractors investments. We agree with the CAS Board and believe that using the Standard to provide for these investment incentives would disguise as an element of cost what is properly an element of profit.

In the course of our preliminary review of the impact of amending or repealing CAS 409 we made concomitant observations on the impact of CAS 414, "Cost of Money as an Element of the Cost of Capital." The purpose of this Cost Accounting Standard is to establish criteria for the measurement and allocation of the cost of capital committed to facilities as an element of contract cost. Using the actual depreciation data from the 7 contractor segments in our preliminary study, we calculated the cost of money applicable to Government contracts for those 5 years of capital assets. The data from the 7 segments was for the 5 year period 1977 through 1981. This period was after CAS 414 became effective. We estimate that under the conditions that existed at each contractor, those 7 segments were reimbursed $511 million under CAS 414 based on the net book value of the 5 years of assets.

Concurrent with the promulgation of CAS 414, DOD through the Profit '76 study revised its profit policy in the attempt to recognize the fact that cost of money for capital committed to facilities would now be an element of contract cost. Previously, this cost had been considered as covered by the profit awarded on a contract. The revision to the profit policy was an attempt to ensure that this cost element would not be recovered both as a cost and also in profit. Based on its Profit '76 study, DOD structured its weighted

guidelines to reduce that profit objective by a factor believed to be representative of the imputed interest allowed as cost. However, in a March 8, 1979, report on DOD's profit policy GAO pointed out that there was insufficient offset to cover the added costs made available to contractors through CAS 414, and thus, average contractor profits increased. Since the GAO report on Profit '76, DOD has increased the range of profit attributable to facilities capital from 6 to 10% to 16 to 20%. We believe this has the probable effect of increasing average contractor profits even further. This emphasizes further the need for considering the combined effects of CAS 409, CAS 414, and DOD profit policy.

One additional point which surfaced during our preliminary study of CAS 409 and CAS 414 has raised questions concerning the extent to which CAS 409 has required contractors to adopt longer asset lives.During the Senate hearings on CAS 409, 10 witnesses gave testimony and 30 additional statements were submitted for the record. Most of the witnesses from industry expressed reservations about the promulgation of CAS 409 because, among other reasons, it would cause asset lives to be lengthened unreasonably thus negatively affecting contractor cash flow. In our survey of the seven contractor segments we became aware of the fact that six of the seven segments indicated to us that they did not change their asset lives as a result of CAS 409's promulgation. In our continuing industry wide review we have specifically requested contractors to identify changes in asset service lives that have occurred subsequent to CAS 409 so that we can speak more directly to this question.

Before any amendment or repeal of CAS 409 is made, we believe that at the very least, the combined effect of CAS 409, CAS 414, and DOD profit policy should be thoroughly evaluated to assess their

total impact. We believe that the results of our current industry wide study should provide data to help resolve these issues.

GAO VIEWS ON THE COST ACCOUNTING STANDARDS BOARD FUNCTION

You requested our views on (1) the need to reestablish the Board function and (2) the desired location if such a need exist. We have mentioned earlier in this statement there is some controversy surrounding CAS 409. A continuing Board function, we believe, would aid in resolving this type of issue.

Our views on the need for a Board function and its preferred location were addressed in a report we sent you on May 3, 1983. The basic elements of that report are covered below.

The GAO, through its oversight role of government procurement operations, has conducted reviews of the implementation of the Standards and the Defense Contract Audit Agency's (DCAA's) role in monitoring contractor compliance with the Standards. Currently, GAO has several ongoing assignments dealing specifically with selected standards. While GAO's work to date has shown that Federal departments and agencies implementation of the Standards is generally good and DCAA's CAS compliance determinations appear reasonable, GAO believes that, with the passage of time, the need to reactivate some form of a Board function increases. It appears increasingly more difficult for contractors, agency officials, and those charged with resolving CAS-related disputes to continue to operate efficiently without the aid and benefit of a Board. The environment in which the Standards exist continues to change while the Standards themselves remain fixed. Our belief is predicated on numerous problems which

would either be resolved or dramatically improved if a Board were in operation. Some examples of these problems which have arisen since the Board ceased to operate are discussed briefly below.

--Without a Board there is no body empowered to grant waivers and exemptions to the Standards; yet it was the apparent intent of the Congress in the authorizing legislation to have a body to consider the need for waivers and exemptions. Recently the National Aeronautics and Space Administration (NASA) used authority under P.L. 85-804 to grant relief from CAS coverage.

--From time to time during the Board's life, it felt the need to provide interpretations of the Standards when there was a widespread and serious question of the Board's intended meaning. As discussed previously, such a question exists around the intended use of a special provision of CAS 409. DOD recently issued a memo to its procurement officials encouraging the use of this special provision. Members of Congress have expressed concern that this memo may focus undue attention and emphasis on what is essentially an exception provision of the Standard. This situation is a question that a continuing CAS Board may well wish to review.

For these reasons and others that will arise in connection with the dynamics of accounting for defense contracts, GAO believes that a body of work exists that is signficant enough to warrant the reactivation of a Board.

2. Appropriate Location for the Board Function

In expressing our views on the appropriate location for a reactivated Board, two features should be discussed:

1. The Standards are founded in well-reasoned accounting theory. The Board and its staff put extensive effort into researching, drafting, soliciting comments, and revising drafts on the Standards. The Board discussed at length the proposed Standards and was not satisfied until it had heard the salient arguments for or against the Standards. As a testament to their work, it should be noted that none of the 19 Standards was rejected during the 60 day period that each was required by law to lie before the Congress. In all their efforts, the Board and its staff strove to maintain and promote good accounting in an effort to increase uniformity and consistency in accounting for costs on defense contracts. This devotion to sound accounting was a paramount consideration to the Board and staff. GAO considers it imperative that any continuing Board function have sufficient accounting expertise and experience to maintain the cost accounting integrity of the promulgated Standards.
2. The second critical feature which must be addressed is independence of this cost accounting activity from the economic and incentive factors which influence Federal procurement policy. This independence was one of the primary features sought by the Congress in authorizing the Board under P.L. 91-379 which provided that the Board be an agent

of the Congress and independent from the executive branch. With the establishment of the Board, determinations as to the proper methods for measurement and allocation of cost were established by accountants who were independent of the Federal procurement process. GAO believes that this independence was intended by the Congress and that the same independence should be maintained in any continuing Board function.

GAO believes, therefore, that any Congressional action on the location of the Board function must ensure the availability of adequate accounting expertise and independence. There are two options for location of a continuing Board function which, if chosen, would in the opinion of GAO satisfy the criteria discussed above.

The option preferred by GAO would be for the Congress to appropriate a limited amount of funds to the original authorizing legislation, P.L. 91-379. The necessary funds would cover the compensation and travel of the Board members appointed from private life as prescribed in P.L. 91-379. GAO, with some augmentation of its staff, would provide the primary staff support for the Board. This action would revitalize the Board and satisfy the criteria of independence and the availability of accounting expertise at reduced costs to the Federal Government.

A secondary option is to issue new authorizing legislation to empower the Comptroller General as the head of GAO to perform all duties and functions that belonged to the Board. Provisions could be

made for an Advisory Board similar to the prior Board's make-up which could advise the Comptroller General of the affected parties' views. GAO, with some augmentation of its staff, would perform the support duties. As with the previous option, reactivating the Board function would be accomplished, while ensuring independence and providing accounting expertise at a reduced cost to the Federal Government.

Mr. Chairman, this concludes my prepared statement. I would be pleased to answer any questions you or members of the Committee may have.

FOR RELEASE ON DELIVERY
Expected 10:00 a.m.
May 19, 1983

Statement by Deputy Inspector General
Department of Defense
Derek J. Vander Schaaf, on the Effectiveness of
Cost Accounting Standard 408
before the Committee on Governmental Affairs
United States Senate
May 19, 1983

Mr. Chairman and Members of the Committee:

I am pleased to testify today on the impact of Cost Accounting Standard 408 on Defense contract costs.

Some of the standards issued by the former Cost Accounting Standards Board were based on accrued accounting principles. This was done to ensure that certain costs were assigned to the cost accounting period in which the contractor became liable for payment of costs even though the contractor may not actually pay such costs until subsequent accounting periods. Cost Accounting Standard 408 is one such standard that is based on accrued accounting principles. Standard 408 provides that the "cost of compensated personal absences shall be assigned to the cost accounting period or periods in which the entitlement was earned."

We in the Inspector General community agree with the use of accrual accounting for compensated personal absences and

strongly endorse these cost accounting principles. However, we are concerned about the timing of reimbursements to contractors for such accrued costs. We are especially concerned when the contractor accrues the costs but doesn't pay them until much later.

To illustrate, consider accrued vacation costs, the major category of compensated personal absence costs. It often takes 18 months between the initial accrual of vacation costs and the contractors' actual payment for them. No one, to my knowledge, has analytically quantified the amounts of accrued vacation costs, but we estimate that it approaches $2 billion dollars annually. With large accrued vacation costs and the current high rates of progress payments under fixed price contracts, it is possible that current progress payments to contractors could exceed their actual outlays of cash. This would also be true for cost-type contracts. If this is true, the Government could be providing some contractors with interest-free loans. The U.S. Treasury would be paying significant interest costs for what are, in effect, cash advances.

In June 1982, I proposed to the Under Secretay of Defense for Research and Engineering that he consider limiting contract payments for vacation expense to the amounts actually paid by

contractors. My proposal was similar to current DoD practices for certain other accrued costs. For example, DoD contract clauses preclude reimbursement to contractors for accrued pension costs until the contractor has paid into a pension fund. Also, under the standard progress payment clause, DoD contractors can only receive payments from the Government after they pay for items purchased from subcontractors.

The Under Secretary of Defense for Research and Engineering did not think that changing reimbursement practices for accrued vacation was warranted or practical. He stated that the flexible progress payment concept considered contractor float for all accrued expenses in determining the amount of progress payments. The correspondence on this matter between my office and other DoD organizations has been made available to the Committee at your request and provides additional information on this issue.

The objective of the flexible progress payment procedures is to tailor more closely the payment rate to the cash needs of a contractor for a particular contract. The flexible payment rate is determined through the use of a DoD Cash Flow Computer Model referred to as Cash II. The use of flexible progress payment procedures is optional for fixed price type contracts. We are concerned that this "system" of progress payments is now

being widely used without any followup studies or audits to ascertain the accuracy of the flexible progress payment model. Computer models are notorious for the ways they can be "gamed" to produce a desired outcome. In addition, my office is unaware of any audit that has been done of an entire contract being administered under flexible progress payments to determine what was the real cash flow situation as opposed to the cash flow predicted by the model. Thus, there has been no independent verification of this system of flexible progress payments.

After recruitment of the 100 contract audit positions authorized the Defense Inspector General under Public Law 97-252, we plan to perform an audit of the equity and cost impact of current policies for funding in advance contractor's accrued vacation costs. This audit will also include an evaluation of the flexible progress payment procedures, including both the model itself and audits of contractors using the model.

Our concerns on the reimbursement of accrued vacation expenses would be abated, if not eliminated, if current progress payment rates were lowered to where they were a few years ago, 80 percent for a large business and 85 percent for a small business. I recognize that during the recent period of rapid inflation and high interest rates, DoD tried to ease the

financial burden of contractors by increasing the progress payment rates. Interest rates as high as we recently experienced have only happened once in the last century. With a decrease in inflation and interest rates closer to historical levels, I believe that it is time for DoD to reconsider its current progress payment rates to ensure that contractors are not provided additional profits through the interest-free use of Government funds.

One last point. We believe that there is a continuing need to review and update the Cost Accounting Standards. Therefore, the Office of the Inspector General supports the creation of a new Cost Accounting Standards Board.

Mr. Chairman, that completes my statement. I am ready to answer any questions you may have.

Chairman ROTH. At this time we would like to call forward the next panel: Mr. Charles O. Starrett, Jr., Director, Defense Contract Audit Agency; Mr. Bertold Bodenheimer, CPA, Vice President, McGrow, Pridgeon and Co., CPAs; and Mr. Frederick Neuman, CPA, Special Consultant with Peat, Marwick, Mitchell & Co., CPAs.

Gentlemen, I am pleased to welcome each and every one of you. As you heard me tell the preceding panel, it is our intent to include each of your statements as if read. I would ask that you summarize and keep within a 10-minute timeframe.

Mr. Starrett, do you want to proceed?

TESTIMONY OF CHARLES O. STARRETT, JR., CPA, DIRECTOR, DEFENSE CONTRACT AUDIT AGENCY; BERTOLD BODENHEIMER, CPA, VICE PRESIDENT, McGROW, PRIDGEON & CO., CPAs; AND FREDERICK NEUMAN, CPA, SPECIAL CONSULTANT WITH PEAT, MARWICK, MITCHELL & CO., CPAs

Mr. STARRETT. Yes, Mr. Chairman, in accordance with your request, let me summarize the statement that I submitted for the record.

Your staff has advised that testimony desired from me should address the need for reestablishing a Cost Accounting Standards Board. I can say unequivocally that I favor having an accounting organization with authority similar to that of the Cost Accounting Standards Board.

My agency—the Defense Contract Audit Agency—works with cost accounting standards daily. We review disclosure statements for adequacy of disclosure and compliance with cost accounting standards; we review actual and proposed accounting practices for compliance with the standards; and we review cost impact proposals to see whether they accurately reflect the impact of noncompliance or of changes to cost accounting practices.

Our experience with CAS gives us a vantage point from which to identify issues that need to be addressed by an organization with resources to adequately study the issues and authority to institute appropriate action. Let me illustrate some of the issues.

CAS compliance is achieved through the contract process. This includes formal disputes proceedings when contractor and Government representatives disagree on the compliance of particular cost accounting practices. The Board of Contract Appeals, a group of nonaccountants, gets to decide which accounting practices comply with the accounting standards. Inappropriate interpretations may result. For example, the standard on home office expense allocations includes criteria for allocating State franchise taxes to segments. The Government implementation recommendations were supported by CAS Board representatives as being correct. Yet the Board of Contract Appeals ruled in favor of the contractor, setting a precedent that is costing the Government millions of dollars. The CAS Board attempted to take corrective action, but it was not able to do so before it ceased operations.

The CAS Board published materiality criteria which are generally regarded as excellent. However, the one dealing with the impact on Government funds needs clarification. Its description discusses

only Government versus nongovernment impact. The impact between Government programs can also be very significant to Government budget and planning considerations. We believe the criterion's description should be expanded to cover this point.

The Department of Defense CAS Steering Committee published 25 guidance papers on CAS implementation. They should be reviewed for possible incorporation into the CAS regulations.

Other illustrations are included in my detailed statement which was submitted for the record.

DOD's experience with its regulatory cost principles also points to the need for a Board. Over the years DOD has had to review and update the cost principles in response to the increasing complexity of business in general and Government contracting in particular. DOD has long had a committee charged with keeping the cost principles up to date. It is an active committee. It seems obvious that cost accounting standards require similar continuing attention.

The structure and placement of the cost accounting standards organization has been the subject of considerable discussion and varying opinions. Perhaps an overall objective for the organization should first be identified, then the path of least resistance can be taken to achieve the objective.

I believe that most parties involved would agree that the organization should be structured so that it has sufficient independence to fairly represent unbiased and competent professional accounting views. In other words, the organization should be primarily concerned with assuring that CAS reflects the most appropriate accounting practices for determining the actual costs of performing Government contracts.

One of the most discussed issues about the CAS Board's organization dealt with whether it should be in the legislative branch of the Government. It seems to me that the concerns expressed by those advocates of having the organization in the legislative branch could be satisfied by having it structured to meet the objective I described. Then placing such an organization in the executive branch would satisfy the advocates of that positioning. This should permit avoiding the legislative versus executive branch of the Government debate.

To achieve the objective, the placement should be where it has both the perception as well as the realized independence. Having it as part of the Office of Management and Budget would probably do this. Since we are talking about an accounting organization, placement in the financial management side of OMB would be preferable.

If the organization's objective is to promulgate standards for cost accounting, most certainly its membership and staff should be comprised of accountants with expertise in Government contract cost accounting. I do not see a particular need for the membership to include nongovernment representatives, as did the CAS Board. Representation from the Government agencies responsible for including CAS in their contracts should suffice as long as the usual opportunity for public comments is afforded.

As to the promulgation authority of the CAS organization, I believe it should have full authority to establish new standards as well as modify existing standards. Otherwise the organization

would be stuck with the task of trying to force-fit new issues into the 19 existing standards. That would result in confusion and unwieldy standards. There is no reasonable logic to restrict the organization from dealing with new developments in operations which require new consideration in cost accounting practices.

I thank you for this opportunity to provide my views. I will be ready to answer questions.

Chairman ROTH. Thank you.

Mr. Bodenheimer?

Mr. BODENHEIMER. Senator, I greatly appreciate this opportunity to present my views on various issues concerning the need for oversight of cost accounting standards. I am presently with the accounting firm of McGrow, Pridgeon & Co., P.A., certified public accountants. Prior to joining this firm, I was with the Cost Accounting Standards Board staff virtually during the entire time of its existence. Before joining this staff, I had about 18 years of experience with the Defense Contract Audit Agency. During much of that time I was a member of or chairman of the part 2, section XV Cost Principles Subcommittee. Accordingly, my views come from the perspective of not only having worked with the cost accounting standards setting process but also with the DOD regulatory process and now from the perspective of the public accounting experience.

Cost accounting standards have become an important tool in the Government acquisition process. Indeed, it is difficult to imagine a Government contracting environment today without these standards. However, like any other tool, without proper care and maintenance, the standards will inevitably deteriorate, become useless and possibly even dangerous.

I consider the absence of an authority to make interpretations, modifications, additions, or deletions to cost accounting standards and Cost Accounting Standards Board regulations or to grant waivers to be a serious and urgent procurement problem. The lack of an organization to grant waivers and exemptions appears to be one of the most immediate problems.

This authority was expressly provided to the Cost Accounting Standards Board in Public Law 91-379. Although the CASB used this authority sparingly, the need for waivers is self-evident. Occasions inevitably arise for sole source acquisitions, emergency acquisitions or other situations, where the requirement to use cost accounting standards would be inappropriate or impractical. Such situations certainly came up during the life of the Board and undoubtedly continue to arise.

It is my understanding that at least one agency has resorted to Public Law 85-804 to grant the necessary waiver. However, I understand the use of that authority for this purpose is cumbersome and inappropriate. New authority is required to exercise this important function of waivers.

Another serious problem is the absence of an authority to interpret existing standards. In spite of the best efforts of the Cost Accounting Standards Board to promulgate clear and unambiguous standards, it is inevitable that reasonable people will differ as to their meaning. During its lifetime, the CASB resorted to interpretations sparingly and reluctantly, perhaps too sparingly in my opinion. Only three interpretations were issued during the life of

the Board. The absence of an interpretation mechanism can be expected to lead to an increased number of contract cost disputes. As a result, the Boards of Contract Appeals will become the interpreters of standards. There is ample evidence that this process is producing mixed results, at best.

Mr. Starrett has already referred to a number of ASBCA cases where the interpretations were contrary to the intent of the Cost Accounting Standards Board.

A clear example of the undesirable result of this process is provided by the various decisions of the Armed Services Board of Contract Appeals on disputes concerning the allocation of State income taxes to segments of a corporation, to which Mr. Starrett has already referred.

To date, Lockheed, McDonnell Douglas, and Grumman all have appealed to the Armed Services Board of Contract Appeals from contracting officer decisions which held that their methods of allocating State income taxes to segments—and subsequently to contracts—violate CAS 403.

The Armed Services Board of Contract Appeals upheld the appeal of Lockheed and Grumman and directed McDonnell Douglas and the Government to negotiate a settlement on the basis of principles established by the Armed Services Board of Contract Appeals.

In my opinion, all of the ASBCA decisions on these appeals are clearly contrary to the intent of CAS 403 and also conflict seriously with each other. Perhaps most seriously, according to the Armed Services Board of Contract Appeals, those contractors that allocate State income taxes to their segments as intended by the Cost Accounting Standards Board are now actually in violation of CAS 403, an obviously absurd result. In short, these decisions have wrought chaos from an attempt to achieve uniformity and point up the need of a new authority to remedy existing problems.

In addition to the need for interpretation, there may also be a need for modifications to existing standards. Although I firmly believe that the basic cost accounting principles incorporated in the standards continue to be sound and will remain so for a long time to come, there are external influences which may cause a need for modifications in both the existing standards and regulations.

For example, inflationary factors, increases of decreases in the defense budget, or even industry pressures may dictate the desirability of modifying certain thresholds incorporated in CASB standards and regulations.

To illustrate, the current trigger for cost accounting standards applicability is a negotiated contract of more than $500,000. If inflation continues, there may well need to be a change in this kind of threshold which is incorporated throughout the standards and CASB regulations.

Finally, perhaps most importantly, in the area of modifications, there are those from both industry and the Government who believe that certain standards or CASB regulations are contributing to inappropriate results. Notable examples, which have been mentioned frequently here this morning, include the allocation of vacation pay under cost accounting standard 408, the asset lives to be used under CAS 409, and the allowance for cost of money under

CAS 414. There are other standards where I understand either industry or the Government is dissatisfied with the result.

I firmly believe that in the interest of fairness and good Government, those that perceive significant problems with existing standards should have the opportunity to be heard by an authority empowered to take corrective action.

Finally, I would like to mention that there may be a need for certain additional standards. Before the Cost Accounting Standards Board ceased operations in 1980, its chairman had expressed the view that the work it had set out to do had been substantially completed. Nevertheless, it should be noted that the CASB had foreseen the need for certain additional standards on costs not yet covered. Significant among these are such costs as selling and marketing costs, deferred development costs, costs of special facilities such as wind tunnels and space chambers, and joint product costs.

Research on all of these subjects was planned or in progress when the Cost Accounting Standards Board ceased to function because of a lack of funds. Clearly then there are important voids in the existing body of cost accounting standards which need to be considered by a new CAS authority.

In light of the existing and potential CAS problems, I believe the appointment of a new CAS Board or similar authority is essential. In the absence of an authority to grant waivers, make interpretations and modifications, revise regulations and possibly issue some new standards, CAS problems will eventually become intolerable for both the Government and contractors alike.

To be effective, any such new authority must be essentially the same as is now provided to the CASB by Public Law 91-379; that is, the power to promulgate and amend standards and rules and regulations for their implementation. I recognize that there are those who believe that any new organization should not have the authority to promulgate additional standards. However, like Mr. Starrett, I would consider it a serious error to restrict any new organization in this manner. Any restriction against the promulgating of new standards would amost certainly result in continual disputes as to whether a particular subject represents an interpretation or modification of an existing standard or the promulgation of a new standard.

Having concluded that the continuation of CAS functions is essential, there remains the question of the location and form of the organization.

In the deliberations leading to the passing of Public Law 91-379, the basic question was whether the authority for CAS should rest with the legislative or executive branch. Indeed, this question never fully subsided during the life of the CASB.

In my opinion, whether the CAS function should be in the legislative or executive branch is not an important issue, provided the responsibility for the function is vested in an independent Board drawn largely from outside the Government.

I recognize, of course, that a CAS function in the executive branch would be perceived by many, both inside and outside of the Government, to be influenced by acquisition policy considerations rather than purely by accounting considerations. However, I believe that this concern is more theoretical than real.

A board of the type provided by Public Law 91-379 likely could not be influenced by outside pressures, regardless of where it is placed within the Government. Nevertheless, because of practical considerations, it seems far preferable to continue the CAS function in the legislative branch.

As already noted, any new hoard to be effective would require essentially the same authority as is now provided in Public Law 91-379. I believe the record shows that this legislation and the resultant modus operandi was quite effective in accomplishing the intent of Congress in establishing cost accounting standards. Under these circumstances, there appears to be no valid reason to seek new legislation to accomplish essentially the same purpose by means of a different organization.

Therefore, I believe the most effective, efficient, economical and prompt means for achieving the much needed continuation of the CAS function would be for the Comptroller General of the United States to appoint new Board members pursuant to the authority already provided in Public Law 91-379.

I might add, however, in view of the fact that the new Board primarily would have a maintenance function, the Board could be supported by part-time staff drawn from other agencies of the Government as is already authorized pursuant to Public Law 91-379.

Therefore, the cost of any new CAS Board operation should be nominal.

That concludes my statement, Mr. Chairman.

Chairman ROTH. Mr. Neuman?

Mr. NEUMAN. My name is Frederick Neuman. I am a CPA and have been a practitioner for almost 50 years. The last 41 years have been in the field of Government contracts, 39 of which I was in Government and the last two years as special consultant to Peat, Marwick, Mitchell & Co. in their Washington office of their Government contract advisory services department.

Before my retirement, my last 5 years with the Government were as Director of the Defense Contract Audit Agency, which, as you know, is the Government agency most responsible for monitoring cost accounting standards. I have had very direct responsibilities for CAS starting with the Comptroller General's Feasibility Study under Public Law 90-37 and continuing through the termination of the CAS Board on September 30, 1980. During 1976 through 1980, I attended all CAS Board meetings as an advisor to the Department of Defense Comptroller and, at the request of its chairman, Mr. Elmer Staats, as a "resource person" for the entire CAS Board.

You have asked me my views regarding the need for a continuing cost accounting standards function for Government contracts and, if one is needed, what the role and authority of such an entity should be. Finally, there is the question as to where the entity should be placed and how it would be structured.

I am both honored and pleased for this opportunity tc respond and thus contribute to your deliberations regarding legislation in this matter.

In 1980 I agreed with the consensus view that the Cost Accounting Standards Board had largely finished its task of promulgating standards. I did not, however, agree that there was no further need

for a governmental function in CAS. I believed then, as each member of the CAS Board testified at the Senate hearings, that a CAS function was still needed, perhaps in an operational mode quite different from that used by the CAS Board from 1971 to 1980. My views are set forth in my full statement in some detail, but I will summarize them as briefly as I can.

First, there is a continuing need to grant waivers from the CAS requirements for contracts where conditions warrant. The two previous witnesses likewise recognize that. No such authority exists since the CAS Board was terminated, except by action of Congress.

Second, there may be a need to modify existing dollar thresholds that are currently fixed in the 19 cost accounting standards and the CAS Board's rules and regulations. Some examples of these are the $100,000 contract threshold, the dollar level in CAS 403 for residual G&A expenses, the dollar level in CAS 404 for capitalization of tangible fixed assets.

Third, there should be ongoing evaluations of the exemptions already granted and others that may be desirable regarding class of contractors and contracts, including the extension of CAS to nondefense contracts.

Fourth, problems have already surfaced concerning the implementation of standards such as CAS 403 regarding allocation of State income taxes. You have heard much on that. Also, CAS 410 on the selection of a proper base to allocate general and administrative costs, et cetera. My full statement cites other examples. These need attention to remedy the problems on a centralized basis rather than through disputes and litigation, which is the situation we now have.

Finally, additional problems were recognized by the CAS Board which were not resolved before the CAS Board ceased to function. Mr. Bodenheimer mentioned a few of those.

So at this point I would conclude that there is a need for a CAS function to perform the following:

One, grant waivers for individual contracts;

Two, establish exemptions for class of contracts or contractors, including the modification of existing exemptions;

Three, modify and amend standards;

Four, issue new standards; and

Five, issue interpretation of standards.

I believe this CAS function should be assigned to the executive branch of the Government and should be placed independent of the agencies and departments which have responsibilities for contract administration. To insure full independence and objectivity, I also believe the function should not be commingled with any procurement policy authority. The Office of Management and Budget would meet my criteria in this regard.

Within OMB, it should be assigned to avery senior staff official and not to the Office of Federal Procurement Policy. The staff should be quite small, perhaps 5 to 10, with much of the required work performed by a cost accounting standards regulatory group, or some other group bearing a similar name, which would be comprised of professional representatives from those executive agencies participating to a major degree in the procurement process. This group would operate largely in a reactive mode and would be advi-

sory to the OMB director who would be authorized to issue the CAS regulation. The OMB director may wish to avail himself of the advice of an outside independent and expert advisory board of professional individuals. This advisory board should be chosen so that it has representation from the accounting profession, academia, contractors, and Government.

All through the process just outlined the private sector as well as the Government should be given ample time to comment and be heard on any proposed rulemaking involving cost accounting standards.

I thank you, and I would be happy to respond to any questions.

Chairman ROTH. Gentlemen, I appreciate your testimony. All of you, of course, see a need for a board, which I agree with. I am not sure where it should be located. I have an open mind on that.

I only have two questions that I would like to ask you, Mr. Starrett, based on your experience. How do problems involving the interpretation of cost accounting standards now get resolved? Are you finding in some instances that the Armed Services Board of Contract Appeals through its decisions is, in effect, revamping or revising and making new cost accounting standards?

Mr. STARRETT. The answer to the first part of your question is that the areas I have described in the statement as problems are being litigated in various courts, or they are before the ASBCA, or we have noncompliance reports that have been issued at the local level and the contracting officers are supporting us in our views on these areas that require clarification, the point being that if the cost accounting standards were clarified, we would not have this expensive route that we would be going.

The answer to the second part of your question is yes, I believe that my statement pretty clearly indicates that in the area of CAS 403, the Board of Contract Appeals has really developed some new rules in this area.

Chairman ROTH. In February your headquarters issued a guidance memorandum to DCAA field offices instructing them that the DeLauer memo of December 1982 should not be interpreted as a change in meaning of CAS 409, nor a lessening of the requirement to comply. Why did you issue this guidance to your auditors?

Mr. STARRETT. Well, this is a normal practice. Anything that comes out of the acquisition community we then distribute to our field so they will be informed of it and can use it as guidance.

We also participated in a committee that resulted in a report going to Dr. DeLauer that finally ended up with the letter that you are referring to from Dr. DeLauer. We were aware of the fact that the cost accounting standard as written cannot be deviated from and simply put that statement in there to make sure that the field level will not deviate from the standard.

Chairman ROTH. Was there a concern that the memo might be construed otherwise?

Mr. STARRETT. Well, I couldn't really say that. This is just something that we normally do in stating our opinion on something, and that is that this is a cost accounting standard and it cannot be deviated from, and the reference to the exception that is in the cost accounting standard has a specific purpose.

Chairman ROTH. Thank you, gentlemen, very much for your testimony. It is very helpful. I am hopeful that Congress will move along the directions you are suggesting.

[The prepared statements of Messrs. Starrett, Bodenheimer, and Neuman follow:]

Statement of

Mr. Charles O. Starrett, Jr.

Director, Defense Contract Audit Agency

Before the

United States Senate

Committee on Governmental Affairs

on

Cost Accounting Standards

Thursday, 19 May 1983

Not for Publication Until Released by the Committee

Mr. Chairman and Members of this Committee:

Your staff has advised that testimony desired from me should address the need for reestablishing a Cost Accounting Standards Board. I can say unequivocally that I favor having an accounting organization with authority similar to that of the Cost Accounting Standards Board.

My Agency--the Defense Contract Audit Agency--works with cost accounting standards daily. We review disclosure statements for adequacy of disclosure and compliance with cost accounting standards; we review actual and proposed accounting practices for compliance with the standards; and we review cost impact proposals to see whether they accurately reflect the impact of noncompliance or of changes to cost accounting practices. Our experience with CAS gives us a vantage point from which to identify issues that need to be

addressed by an organization with resources to adequately study the issues and authority to institute appropriate action. Let me illustrate some of the issues.

CAS compliance is achieved through the contract process. This includes formal disputes proceedings when contractor and Government representatives disagree on the compliance of particular cost accounting practices. The board of contract appeals, a group of nonaccountants, gets to decide which accounting practice complies with the accounting standards. Inappropriate interpretations may result. For example, the standard on home office expense allocations includes criteria for allocating state franchise taxes to segments. The Government implementation recommendations were supported by CAS Board representatives as being correct. Yet, the board of contract appeals ruled in favor of the contractor, setting a precedent that is costing the Government millions of dollars. The CAS Board attempted to take corrective action, but it was not able to do so before it ceased operations.

In March 1980, the CAS Board recognized the need to increase the capitalization threshold in standard 404 from $500 to $1,000. The threshold needs periodic review and revision when appropriate. No practical means exists for doing that.

Standard 408 on accounting for compensated personal absences provides for estimating the liability either in terms of current or anticipated wage rates. It is our understanding that the CAS Board's research indicated that vacations were generally taken and paid within 12 months following the period earned. Since that time, a number of contractors are permitting employees to "bank" vacation earned, i.e. the vacation may not be taken for an extended period

following the period earned. Using "anticipated wage rates" in that circumstance can produce a much larger amount than current rates. We believe the provision should be limited to current rates. In a related manner, standard 415 on accounting for deferred compensation should address those "banked" vacation plans which are in fact more in nature of a deferred compensation plan rather than a compensated personal absence plan.

Standard 410 on allocating business unit general and administrative (G&A) expenses has provisions for selecting an allocation base which need review. It requires use of the cost input base which best represents total activity in a typical period. However, only 3 cost input bases are cited. Another base might better represent total activity, but it could not be used under the current restrictions in the standard. The CAS Board was reviewing this subject when it ceased operation. The review should continue.

Standard 416 on accounting for insurance costs prescribes use of a discount rate equal to that used by states in settling claims. Several states have rates as low as 3 percent which some contractors argue may be applied in discounting all claims. Using such low rates results in grossly overstated accruals of projected losses. This provision should be deleted from the standard or at least clarified.

Standard 416 requires discounting of projected losses to present value when measuring costs of self-insurance plans. It does not address the need for discounting projected losses to present value when measuring costs of purchased plans when payment for elements of the premium cost is deferred. The standard needs to be revised to correct this omission.

Standard 416 makes no distinction between no insurance and self-insurance. There is no definition of "insurance" in the standard. It appears that mere assumption of risk rather than protection against risk is construed to be insurance. Contractors are permitted to accrue self-insurance costs even though there is no provision made for protection against loss. We believe the standard should be revised to include criteria for self-insurance. For example, a provision requiring a demonstration in the accounts that financial capability is available to restore production facilities in the event of loss would be appropriate. Requiring a minimum ratio of assets to liabilities is one way to do this.

Standard 417 on cost of money as an element of the cost of capital assets under construction needs review and clarification regarding identification of what constitutes "construction" (i.e. cost of money is applied) and when the asset is placed in use (i.e. switches over to CAS 414 cost of money accounting).

In implementing Public Law 91-379, the CAS Board regulations established provisions for contract price adjustments plus interest to recover increased costs to the Government arising from CAS noncompliance. However, the law requires the interest rate to be no more than 7 percent. The 7 percent interest provision is hardly an incentive for compliance. We would expect a new CAS Board organization to review and recommend legislation to revise this provision.

The CAS Board published materiality criteria which are generally regarded excellent. However, the one dealing with the impact on Government funds needs clarification. Its description discusses only Government versus non-Government impact. The impact between Government programs can also be very significant to Government budget and planning considerations. We believe the criterion's description should be expanded to cover this point.

The Department of Defense CAS Steering Committee published 25 guidance papers on CAS implementation. They should be reviewed for possible incorporation into the CAS regulations.

These illustrations should not be viewed as all-inclusive. The CAS Board regulations need continuing review in their entirety to assure that they properly reflect the most appropriate cost accounting in the Government contracting environment.

DoD's experience with its regulatory cost principles also points to the need for a Board. Over the years DoD has had to review and update the cost principles in response to the increasing complexity of business in general and Government contracting in particular. DoD has long had a committee charged with keeping the cost principles up-to-date. It is an active committee. It seems obvious that cost accounting standards require similar continuing attention.

The structure and placement of the cost accounting standards organization has been the subject of considerable discussion and varying opinions. Perhaps an overall objective for the organization should first be identified, then the path of least resistance can be taken to achieve the objective. I believe that most parties involved would agree that the organization should be structured so that it has sufficient independence to fairly represent unbiased and competent professional accounting views. In other words, the organization should be primarily concerned with assuring that CAS reflects the most appropriate accounting practices for determining the actual costs of performing Government contracts.

One of the most discussed issues about the CAS Board's organization dealt with whether it should be in the legislative branch of the Government. It seems to me that the concerns expressed by those advocates of having the organization in the legislative branch could be satisfied by having it structured to meet the objective I described. Then placing such an organization in the executive branch would satisfy the advocates of that positioning. This should permit avoiding the legislative versus executive debate.

To achieve the objective, the placement should be where it has both the perception as well as the realized independence. Having it as part of the Office of Management and Budget would probably do this. Since we are talking about an accounting organization, placement in the financial management side of OMB would be preferable.

If the organization's objective is to promulgate standards for cost accounting, most certainly its membership and staff should be comprised of accountants with expertise in Government contract cost accounting. I do not see a particular need for the membership to include non-Government representatives, as did the CAS Board. Representation from the Government agencies responsible for including CAS in their contracts should suffice as long as the usual opportunity for public comments is afforded.

As to the promulgation authority of the CAS organization, I believe it should have full authority to establish new standards as well as modify existing standards. Otherwise, the organization would be stuck with the task of trying to force-fit new issues into the 19 existing standards. That would result in confusion and unwieldy standards. There is no reasonable logic to restrict the organization from dealing with new developments in operations which require new consideration in cost accounting practices.

Thank you for this opportunity to provide my views; I'll be happy to respond to your questions.

TESTIMONY OF BERTOLD BODENHEIMER
BEFORE THE UNITED STATES SENATE COMMITTEE ON
GOVERNMENTAL AFFAIRS

ON THE NEED FOR A COST ACCOUNTING STANDARDS BOARD
MAY 19, 1983

I. Introduction

I greatly appreciate this opportunity to present my views on various issues concerning the need for oversight of Cost Accounting Standards. I am presently with the accounting firm of McGrow, Pridgeon & Company, P.A., Certified Public Accountants. Our firm provides auditing, accounting, and management advisory services to a large variety of clients, primarily in the Baltimore and Washington, D.C. areas. A significant number of our clients are government contractors, although the majority are not. We provide consulting services on government contract accounting and administrative requirements to both small businesses and large corporations, as well as to various government agencies.

Prior to joining McGrow, Pridgeon & Company, P.A., I was on the staff of the Cost Accounting Standards Board (CASB) for virtually the entire time of its existence. Before joining the staff of the Cost Accounting Standards Board, I had about 18 years of experience with the Defense Contract Audit Agency and predecessor organizations.

During that time I served for about 6 years on what was then the Part 2, Section XV ASPR Standing Subcommittee and was the chairman of that subcommittee for about 3 years. The Subcommittee was responsible for developing and maintaining cost principles used to determine allowable costs under Government contracts.

Accordingly my views are from the perspective of substantial experience with both the Department of Defense (DoD) regulatory process and the standard setting process of the Cost Accounting Standards Board, as well as experience with a public accounting firm.

II. The Need for a CAS Oversight Function

Cost Accounting Standards have become an important tool in the government acquisition process. Indeed it is difficult to imagine a government contracting environment today without these Standards. However, like any other tool, without proper care and maintenance, the Standards will inevitably deterioriate, become useless and even dangerous. There is evidence that this deterioriation process has already begun. It is unrealistic to assume that the Standards

and regulations issued by the CASB will continue to be appropriate forever. The cost principles in Section XV of the Defense Acquisition Regulation (DAR) and the Federal Procurement Regulation (FPR) provide a good example as to the need for change. Although originally published in their present form in 1959, there have been additions, deletions and revisions to these cost principles almost without interruption ever since that time. Under the circumstances I consider the absence of an authority to make interpretations, modifications, additions, or deletions to Cost Accounting Standards (CAS) and CASB regulation to be a serious and urgent procurement problem. Likewise, the absence of an authority to grant exemptions or waivers from Cost Accounting Standards and regulations in limited circumstances constitutes a potentially serious problem. These matters are more fully explored in the following paragraphs.

A. Exemptions and Waivers

One of the most immediate problems appears to be the absence of an authority to grant exemptions and waivers. This authority is expressly provided to the CASB in PL 91-379 (Section 719(h)(2)). Although the

CASB use this authority sparingly, the need for waivers is self evident. Occasions inevitably arise for sole source acquisitions, emergency acquisitions or other situations, where the requirement to use Cost Accounting Standards would be inappropriate or impractical. Such situations certainly came up during the life of the Board and unquestionably continue to arise. It is my understanding that at least one agency has resorted to PL 85-804 to grant the necessary waiver. However, I consider the use of that authority for this purpose would be cumbersome and inappropriate. New authority is required to exercise this important function promptly if required.

B. Interpretations

In spite of the best efforts of the CASB to promulgate clear and unambiguous Standards, it is inevitable that reasonable people will differ as to their meaning. During its lifetime, the CASB resorted to Interpretations sparingly and reluctantly - perhaps too sparingly in my opinion. Only 3 interpretations were issued during the life of the Board. The absence

of an appropriate authority to interpret Standards can be expected to lead to an increased number of contract cost disputes. As a result the Boards of Contract Appeal will become the interpreters of Standards. There is ample evidence that this process is producing mixed results, at best.

In my opinion it would be a serious error to rely on the disputes process as a means of interpreting Standards. To begin with, such an approach would be directly in opposition to one of the stated purposes of the CASB - i.e., the reduction of disputes. More importantly, it would forfeit the process of developing Cost Accounting Standards to non-accountants. A clear example of the undesirable results of this process is provided by the various decisions of the Armed Services Board of Contract Appeals (ASBCA) on disputes concerning the allocation of taxes among the segments of a corporation, pursuant to CAS 403. To date, the Boeing Company, the Lockheed Corporation, McDonnell Douglas Corporation, and Grumman Corporation all have appealed to the ASBCA from contracting officer decisions which held that their methods of allocation violate CAS 403.

In my opinion certain of the ASBCA decisions on these appeals are clearly contrary to the intent of CAS 403 but also conflict seriously with each other. Perhaps most seriously, according to the ASBCA, those contractors that allocate taxes to their segments as intended by the CASB, are actually in violation of CAS 403 - an obviously abused result. In short, these decisions have wrought chaos from an attempt to achieve uniformity and point up the need of an authority to remedy existing problems.

Another means for filling the interpretation void has been the memoranda issued by the DoD CAS Working Group. As part of its function to establish policy guidelines for CAS administration, the working group published 25 memoranda on a broad range of CAS implementation problems. Many, if not most, of these memoranda are actually in the nature of interpretations of the CASB Standards and regulations. During the life of the Board, the Working Group memoranda were frequently coordinated with the CASB staff. As a general rule, these memoranda provide carefully researched, well written guidance to contracting personnel. Nevertheless it should be recognized that this guidance is not

binding on contractors and, of course does not qualify as official interpretation. Moreover, the possibility of coordinating such guidance with the CASB or its staff no longer exists. In my opinion the need exists for a comprehensive review of the Working Group memoranda by a new authority to determine which, if any, warrant adaptation as formal interpretations or modifications of Cost Accounting Standards.

In connection with the subject of interpretations, it is also important to note that the ASBCA has questioned the authority of even the CASB itself to issue "Interpretations", per se. (ASBCA 19842, 80-2BCA14508, McDonnell Douglas Corporation.) According to the ASBCA, an Interpretation is not "binding or determinative" unless it is properly promulgated pursuant to PL 91-379. In other words, "Interpretations" are considered valid by the ASBCA only if they are promulgated as modifications to existing Standards. Pursuant to this decision, only the CASB could issue a valid interpretation and the function presumably could not be assumed by another organization, except perhaps the Congress - an obviously impractial solution.

In summary, in the absence of an appropriate authority to interpret Standards promptly, a variety of unsatisfactory means would have to be used to fill the vacuum. An authoritative body is required to fulfill this much needed interpretatio.. function.

C. Modifications

Although I firmly believe that the basic cost accounting principles incorporated in the Standards continue to be sound and will remain so for a long time to come, there are external influences which may require modifications in both the existing Standards and Regulations. More specifically, inflationary factors, increases or decreases in the defense budget, or even industry pressures, may dictate the desirability of modifying certain threshholds incorporated in CASB Standards and Regulations. For example, the current "trigger" for CAS applicability is a negotiated contract of more than $500,000 (4CFR331.30); the authority to use modified coverage is available if covered contracts in the previous fiscal year were less than $10,000,000 or 10% of total sales

(4CFR332.30); and the requirement to file a disclosure statement arises if a contractor received more than $10,000,000 of covered contract the previous fiscal year (4CFR351.40). In addition there is a percentage of sales threshhold for the requirement to allocate residual home office expenses pursuant to the 3 factor formula in CAS 403. All of these matters deserve continued surveillance and an authority to make appropriate revisions if necessary.

In addition there are other provisions of Standards which may become obsolete because of external influences. For example, CAS 409, Depreciation of Tangible Capital Assets, states that the method of depreciation used by contractors for financial accounting purposes shall also be used for contract costing unless "the method is unacceptable for federal income tax purposes." (Para. 409.50(f)(1).) For most assets placed in service after 1980, the Internal Revenue Code requires assets to be depreciated by the use of either the Accelerated Cost Recovery System (ACRS) or by optional straight-line depreciation. The Internal Revenue Code therefore no longer permits the use of the

accelerated depreciation methods, such as declining balance or the sum-of-the- years'-digits, which were available when CAS 409 was promulgated. Under the circumstances it may be appropriate to modify CAS 409 to maintain its original intent to permit the use of such accelerated methods. In the absence of an organization with CAS functions, changes such as this obviously cannot be made.

Finally there are those from both Industry and the Government who believe that certain Standards or CASB regulations are contributing to inappropriate or inequitable results. Notable examples, which I understand are of particular interest to the Senate Committee on Governmental Affairs, include the allocation of indirect expenses to unallowable costs under CAS 405; the costs of accrued vacation pay under CAS 408; the depreciable lives to be used under CAS 409; and the allowance for cost of money under CAS 414. I believe that in the interest of fairness and good Government, those that perceive significant problems with existing Standards should have the opportunity to be heard by an authority empowered to take corrective action.

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D. Additional Standards

Before the CASB ceased operations in 1980, its chairman expressed the view that the work it had set out to do had been substantially completed. Nevertheless, it should be noted that the CASB had foreseen the need for certain additional Standards on costs not yet covered. Significant among these are selling and marketing costs, particularly in regard to foreign military sales. There is considerable question as to whether the current provision in Section XV of the DAR on this subject is consistent with the CASB philosophy of indirect cost allocation. As another example, the CASB had specifically reserved the question of deferred development costs for additional research and the possible development of a Standard on deferred development costs. These costs are specifically excluded from coverage under CAS 420, IR & D and B & P costs. In still another example, CAS 418, Direct/Indirect Costs, specifically excludes the cost of "special facilities" accounted for in separate indirect cost pools. At issue are such frequently controversial costs as those for space chambers, wind tunnels, reactors and the like. Time did not permit the CASB to conduct further research on this important subject.

Another project which the CASB could not complete was the difficult subject of costing so called joint products. Although the initiation of the research for a Standard on joint product costing was directly traceable to the problem of acquiring petroleum products without competition in a time of energy shortages. The subject should be pursued for possible future use.

Clearly, then, there are important voids in the existing body of Cost Accounting Standards which need to be considered by a renewed CASB function.

E. Disclosure Statements

The CASB considered the Disclosure Statements required by Part 351 of its regulations one of its most important accomplishments. The Disclosure Statement is an invaluable tool in understanding a contractor's accounting system, in monitoring compliance with CAS 401 and 402, and in the administration of the contract adjustment provisions required for changes in a contractor's cost accounting practices (4CFR331.50). Nevertheless, it appears that many parts of the Disclosure

Statement have become obsolete, both because of Cost Accounting Standards promulgated by the CASB itself and because of external influences such as those mentioned above. In my opinion, therefore, this important document is in need of comprehensive review and possible revision.

III. Authority of a New Board

In light of the existing and potential CAS problems, I believe the appointment of a new CAS Board or similar authority, is essential. In the absence of an authority to grant waivers, make interpretations and modifications, revise regulations, and possibly issue some new Standards, CAS problems will eventually become intolerable for both the Government and contractors alike. To be effective, any such new authority must be essentially the same as is now provided to the CASB by PL 91-379; i.e., the power to promulgate and amend Standards and rules and regulations for their implementation. I recognize that there are those who believe that any new organization should notv have the authority to promulgate additional Standards. However, I would consider it a serious error to restrict any new organization in this

manner. Any restriction against promulgating new Standards would almost certainly result in continual disputes as to whether a particular subject represents an interpretation or modification, of an existing Standard or the promulgation of a new Standard. Accordingly, no such restriction should be placed on any new authority.

IV. Structure of a New Board

Having concluded that the continuation of CAS functions is essential, there remains the question of the location and form of the authority. In the deliberations leading to the passing of P.L. 91-379, a basic question was whether the authority for CAS should rest with the Legislative or Executive Branch. Indeed, this question never fully subsided during the life of the CASB and apparently is still considered by some to be an important issue today.

In my personal opinion, whether the CAS function should be in the Legislative or Executive Branch is not an important issue, provided the responsibility for the function is vested in an independent Board drawn largely from outside the Government. Of far greater importance is the quality

and qualifications of the Board and the adequacy of the support staff. I recognize, of course, that a CAS function in the Executive Branch would be perceived by many, both inside and outside of the Government to be influenced by acquisition policy considerations, rather than purely by accounting considerations. However, I believe that this concern is more theoretical than real. A Board of the type provided by PL 91-379 likely could not be influenced by outside pressures, regardless of where it is placed within the Government. Nevertheless because of practical considerations, it seems far preferable to continue the CAS function in the Legislative Branch.

As noted above, any new Board, to be effective, would require essentially the same authority as is now provided in PL 91-379. I believe the record shows that this legislation and the resultant modus operandi was quite effective in accomplishing the intent of Congress in establishing Cost Accounting Standards. Under these circumstances, there appears to be no valid reason to seek new legislation to accomplish essentially the same purpose by means of a different organization.

I believe that the most efficient, economical, and prompt means of achieving the much needed continuation of the CAS function would be for the Comptroller General of the United States to appoint new Board members pursuant to the authority in PL 91-379. However, in view of the fact that the new Board primarily would have a maintenance function, a full time staff to support the Board does not appear to be warranted. Pursuant to Section 719(f) of PL 91-379, the Board is authorized to utilize personnel from the Federal Government. Moreover, Section 719(e) specifically provides that such personnel shall receive no compensation from the Board, but shall continue to receive the compensation of their regular positions. Under these circumstances the envisioned maintenance functions of the CASB could be accomplished with only nominal additional appropriated funds to finance the per diem compensation and travel expenses of the three Board members from the private sector.

Although the final selection of a part-time support staff is the prerogative of the appointed Board, it is appropriate to consider the qualifications and the source of

such a staff. Personnel for this function should be professional accountants with experience in contract cost accounting. A significant proportion of the staff should be certified public accountants. The part-time staff could be drawn from either the Executive or Legislative Branch, and it may in fact be preferable to have representatives from both. Likely sources for this staffing would include, but not be limited to, the Defense Contract Audit Agency, General Accounting Office, Office of Management and Budget, and the Comptroller and Inspector General functions of the Executive Departments.

STATEMENT OF

FREDERICK NEUMAN, C.P.A.
SPECIAL CONSULTANT
PEAT, MARWICK, MITCHELL & CO.
WASHINGTON, D.C.

ON

COST ACCOUNTING STANDARDS

BEFORE THE

COMMITTEE ON GOVERNMENTAL AFFAIRS
UNITED STATES SENATE

MAY 19, 1983

Mr. Chairman, Members of the Committee on Governmental Affairs,

My name is Frederick Neuman. I am a certified public accountant and have been a practitioner in the field of accounting and auditing for almost 50 years. During that time I have devoted the last 41 years to the accounting treatment of costs on government contracts. This part of my career began in early 1942 as a staff contract auditor for the Army Air Corps and continued in the Government contract sector until 1981 when, after almost five years as Director of the Defense Contract Audit Agency (DCAA), I retired from Government service. Shortly thereafter, I became associated with Peat, Marwick, Mitchell & Co. as a special consultant in their Government Contractor Advisory Services Department which is headquartered in the Firms' Washington D.C. office. I have been engaged with Peat Marwick for over two years so I have experienced government contracting cost issues and problems from both sides of the contractual agreement.

Specifically dealing with Cost Accounting Standards (CAS), my experience dates back to the Comptroller General's two year feasibility study conducted under P.L. 90-370 when, in a senior staff position in DCAA, I cooperated with the Study Team in obtaining required information and data. Since the creation of the Cost Accounting Standards Board in 1971, I was similarly engaged in many of the needed interrelationships between DCAA and the CAS Board. From 1976 to its last meeting in September 1980 I attended all the CAS Board meetings and, as Director, acted as consultant to the Department of Defense Comptroller as well as a "resource person" for the entire CAS Board. This latter role was at the request of the CAS Board Chairman, Mr. Elmer B. Staats, Comptroller General of the United States.

I have gone into some detail to provide you with an overview of my extensive involvement with Cost Accounting Standards and I'm very pleased and honored to share my views with you today. While I appear before you as a Special Consultant for Peat, Marwick, Mitchell & Co., the views I express today are solely mine and they do not necessarily reflect those of the Peat Marwick management.

I understand this committee is considering whether any legislation should be enacted to provide for some continuing governmental activity in those areas which were formerly conducted by the Cost Accounting Standards Board. I am pleased to offer my views on this question and to provide suggestions as to what I believe to be in the best interests of the public in this regard.

While I agreed with the consensus view in 1980 that the CAS Board had largely completed its work and had fulfilled its mission under P.L. 91-379, I did not agree that a CAS function was no longer necessary. I believed then, and I have not changed my view since, that there were ongoing activities in the evaluation, implementation and all other facets of Cost Accounting Standards for government contracts that warranted a continuation of some governmental authority empowered to act, as necessary and appropriate.

I'm sure there has been increasing evidence since 1980 to demonstrate the need for such an authority. Among the functions of such an authority

would be to assess and evaluate the standards already promulgated and determine the need for modifications, amendments or interpretations of existing standards. Some adjustments may be necessary or appropriate due to ever changing economic conditions which would suggest changes in the dollar thresholds of some of the standards currently in effect. For example, the threshold of $100,000 for CAS covered contracts might warrant change. Similarly, the dollar thresholds in CAS 403 for residual costs and CAS 404 for capitalization of tangible assets may require revision at some future date.

A second area would be a review of the difficulties in the implementation of some standards to determine whether modifications or interpretations are warranted. A number of these needs surfaced even before the Board ceased to function and I will briefly discuss some of those identified areas later.

A third broad area requiring ongoing attention is to respond to request for waivers submitted by the relevant federal agencies. Under the existing CAS Board rules and regulations, no one, other than the Congress, is authorized to grant a waiver from the requirements of CAS. In this same area there should be continuing evaluations to determine the desirability of exempting certain classes of contracts and contractors. It may be appropriate to extend CAS requirements to those contracts and contractors now exempt. For example, I advocate that the Congress consider extending the legislation so that it is not confined to relevant defense contracts but includes contracts with other Executive agencies and departments. Assuming that standards for determining costs of government contracts are necessary or desirable, there is no valid reason for the exemption from statute currently afforded the civilian agencies. Moreover, the present difference between CAS covered contracts and those exempt makes the administration of government contracts unnecessarily difficult for contractors and the government. Additionally, there is evidence of increasing use by the government of the rationale now contained in the CAS for urging contractors to adopt the Standards even on non-CAS covered contracts.

Discussions and deliberations over the past few years highlighted a highly controversial issue regarding any legislation to re-establish or transfer the functions of the Cost Accounting Standards Board. It was whether to permit the promulgation of any new standards. I do not favor the exclusion of this authority for a variety of reasons:

1. Since accounting tracks economic conditions and cannot remain static if it is to reflect the financial and economic factors of conducting business, there may always be a need for some new standard or benchmark to achieve uniformity of treatment. The Financial Accounting Standards Board (FASB) and its predecessor professional bodies have been issuing standards of accountability for its practitioners for many years and to this day is still active. Why should it be different regarding cost accounting standards?

2. The authority to modify or amend any existing standard may well carry with it the implicit authority to issue a new standard. Let me explain. CAS 418 - Allocation of Direct and Indirect Costs currently

provides no guidelines for the treatment of costs to operate a special facility such as a Wind Tunnel or a Space Chamber. During the deliberations of the CAS Board leading to the promulgation of CAS 418, this issue was discussed at considerable length. The CAS Board, however, did not address it in the final promulgation. If the new CAS unit should conclude that there is need for more uniformity in the treatment of such costs, that group could "amend" the existing CAS 418. Is this a new standard, or an amendment of an existing one? The answer is only one of semantics and I would hate to see controversy and litigation ensue to determine the validity of this "amendment". The substance of the question should be on the need for and validity of any new material on CAS, not on its label or the semantics involved.

3. If the CAS function is to be continued, where the authority should be placed is a question on which I will shortly furnish my views. In no event do I believe it should be continued as a Board at the Legislative level. In the Executive Branch, rulemaking functions are regulatory in nature and to preclude any new regulations would be unique and, in my view, contrary to the very authority inherent in any rulemaking governmental entity.

At this point I would like to inject a cautionary note. While I believe that the authority to issue a new standard should not be denied to any CAS regulatory body, I also believe that the authority should be exercised only where there is an identified need for one. I do not believe there is any longer a need for a large professional staff to research and seek out areas for promulgation of new standards as was the operational mode of the now defunct CAS Board.

My conclusions lead me to recommend that the CAS function should incorporate the authority to:

- grant waivers for individual contracts;
- establish exemptions for class of contracts or contractors, including the modification of existing exemptions;
- modify and issue interpretation of existing standards; and
- issue new standards.

I will next address the question regarding where this function should be placed. It has been suggested that the private sector should now take over the task and the FASB should set up a separate group to consider cost accounting issues. I do not think this is a feasible approach because the FASB promulgations have no substance in the law or regulations that would require implementation by contractors. Moreover, there now exists 19 standards that have virtual legislative stature and it would not be consistent to provide for any authority over them to a group outside of government no matter how capable that group might be. This is not to say that the profession should be excluded from making substantial contribution in the maintenance role of the standards.

These appears to be little doubt that the CAS function should be assigned to a governmental entity. In my view, it should not be at the Legislative level but should be in the Executive Branch. I'm sure this committee is aware that the Standards heretofore promulgated by the CAS Board have been challenged as unconstitutional. This issue was raised to the Supreme Court but never decided because the Court ruled on the merits of the issue in the specific case rather than the constitutionality question. To avoid any future litigation of the issue I believe the CAS function should be placed in the Executive Branch and the very first action should be the conversion of all standards, rules and regulations of the CAS Board into an appropriate body of regulations which will be treated in the future in the same manner as other regulations.

Where in the Executive should it be placed? I believe the function should be administered by only highly qualified personnel, with expertise in cost accounting. I also believe that the function should be independent of any entity involved in the operations to which the standards apply. Finally, since I already recommended that the Standards be applicable to all agencies of the Government, the logical placement in my opinion would be in the Office of Management and Budget. While this placement has been under consideration for some time, I add that I do not agree with any delegation or assignment of the function to the Administrator, Office of Federal Procurement Policy (OFPP). While I'm very cognizant that CAS can impact the procurement function in a substantial manner, I nonetheless believe that the standard setting role should be performed independent of the monetary results or other impact of the accounting treatment. On the other hand, I believe the procurement policies could be designed to accommodate any accounting treatment of costs in order to make the accounting results compatible with the desired procurement objectives. To say that another way: Even though the CAS would set guidelines for the measurement and allocation of a specific cost, the cost itself could be declared unallowable, or could be governed by criteria of reasonableness by procurement policy. The measurement, the period of recognition and the allocation of an element of cost all fall under the standard-setting function. Whether it will be recognized as an allowable cost or whether there should be limits placed on the size of the cost will be policies to be set by procurement authorities.

The next matter I would like to address is how this CAS activity should be staffed and how it would function. I envision one Senior Executive Service (SES) high level knowledgeable official assigned to this task with line authority to the Director of OMB. This person should be a career professional and not subject to removal with changes in the administration. This Director or Chairperson should have two or three professional assistants and a similar number of administrative support people. The actual ongoing operational activities will be performed by a Cost Regulation Group which will be formed by designated professional representatives from the agencies primarily involved in CAS type activities such as DOD, NASA, GSA, DOE etc. This CRG will be fully available to requests for CAS action received from the Director; they will not be full time unless the workload demands justify such concentrated performance. They will largely be reactive to identified needs rather than initiating projects on their own or by OMB.

Such a Group, through its Director, would be responsive to requests emanating from a variety of sources that may perceive the need for CAS attention. Suggestions would come from the executive branch agencies, from individual contractors, from industry organizations, from the General Accounting Office and might even be suggested by the accounting profession and academia. The Director would need to examine these requests, explore the significance and need before establishing a project for the Cost Regulation Group (CRG).

The representatives comprising the CRG could call upon advice and assistance from within the agencies they represent. Upon completion of the project objective the CRG would submit its recommendations to the Director, along with the rationale supporting the majority view and the opinions of any dissenters. The Director would have the authority to make the ultimate decision. Before that is done, I recommend that an advisory board independently review and evaluate the CRG position and provide the Director with its views, including and dissenting ones if the recommendation is not unanimous. This Advisory Board would be comprised of high level, experienced professional individuals who will serve on an ad hoc basis for specified periods of time so staggered over the service period so that continuity of the function can be assured. These individuals should be appointed by the Director with the approval of the Director, OMB from the following segments of the accounting and financial community:

Accounting Profession

Academia

Government

Private Sector - Contractors

The deliberations and recommendations of this Advisory Board are not binding on the Director who will have the authority and responsibility to make the final decision. Also assisting the Director will be legal counsel, either furnished by OMB, or assigned to his staff if the workload warrants.

During all the deliberative process described briefly above I assume there will be full public disclosure of the proposed rulemaking and ample time for public response. Where warranted, open public hearings should be held. In short, sunshine provisions should be adopted in the CAS rulemaking process leading to any changes, interpretations or new promulgations.

Earlier I mentioned that there was evidence of the need to evaluate the implementation of the 19 standards already issued. Problems and difficulties have already become evident and some of these were and are to be litigated at considerable cost to both the contractor and the Government. I would like to mention only a few of these but I'm sure that additional ones have surfaced and others will in the future as full implementation of the standards is effected.

CAS 403 - Allocation of Home Office Expenses to Segments

There have already been four Armed Services Board of Contract Appeals (ASBCA) decisions on the Standard's provision regarding the allocation of state income and other taxes to the segments of large defense contractors. One case was appealed through the courts and was only recently ruled on by the United States Supreme Court. Shortly before the CAS Board ceased to function in 1980 an Interpretation was issued to clarify the CAS Board's original promulgation. This Interpretation No. 1 to CAS 403 was referred to but rejected by the ASBCA in its ruling on the issue. This ASBCA action raises a serious question as to the validity of the Interpretation versus the precedence established by the ASBCA decision, both of which are contradictory at this time.

CAS 410 - Allocation of Business Unit General and Administrative Expenses to Final Cost Objectives

In the implementation of this Standard many serious problems arose concerning the establishment of a proper base to allocate these G&A costs to contracts. The DOD CAS Working Group issued guidance on this Standard (Working Group 78-21) in January 1978. They amended the guidance in April 1981. The need for clarification was referred to the CAS Board which considered the issue and indorsed the guidance in WG 78-21. Nonetheless, the CAS Board recognized that the problems in implementation were not resolved. During a good part of 1980, the Board deliberated this issue at great length and was approaching a modification to CAS 410 in order to avoid further costly controversy. Unhappily, time ran out before this could be accomplished. I am aware of at least one major case being disputed before the ASBCA. I believe there are many more still unresolved.

CAS 409. Depreciation of Tangible Capital Assets and
CAS 414 - Cost of Money as an Element of the Cost of Facilities Capital

The issues surrounding both these standards are well known and I will not elaborate on the ones used by those who strongly favor modifying CAS 409 and those who believe that revisions to CAS 414 must be considered if CAS 409 is changed. The positions with respect to both these views are being heard by this Committee so further comment by me is unnecessary.

CAS 418 - Allocation of Direct and Indirect Costs

The actual implementation of this Standard was delayed some two years from the date of issuance and is only being effected at this time. Recognizing the great impact of this Standard on cost determination under Government contracts I am convinced that many problems will surface pointing up the need for further CAS consideration and possible modification of the Standard. One matter that is currently receiving attention is how to account for uncompensated overtime worked by salaried employees. This issue, raised by DCAA under the provisions of CAS 418, is likely to lead to costly disputes. I am also aware that other issues were discussed by the CAS Board but were not covered in the final version. For example, when this Standard was promulgated the CAS Board established a project to review the cost allocation issues surrounding the treatment of the costs of Special Facilities.

Paragraph 331.70(b) - The determination of "increased costs paid by the United States"

This portion of the CAS Rules and Regulations has been a focal point for considerable controversy. While the CAS Board heard many presentations from the private sector on the inequity and impropriety of this provision the Board did not issue any change. There may well be instances where significant money is at stake that will go to litigation before being resolved.

DOD CAS Steering Committee and Working Group

The Guidance for implementing CAS has been issued by this group in the form of interim guidance called "Working Group Item xx-xx". Some of these guidelines may well be implemented and appropriately issued by DOD. On the other hand, other provisions might be in the nature of regulatory material and should be issued by a duly constituted rulemaking entity. If all the Standards are reconstituted as regulation when a CAS function is established in the Executive Branch, that group should review all the Working Group instructions for possible reissuance in the same form, or with changes, as regulatory material. As matters now stand, the government officials are bound to follow the Working Group guidance but none of its provisions is binding on contractors. This situation is a fertile ground to spawn costly disputes and should be remedied at the earliest possible time.

This concludes my presentation. I would again like to thank the Committee for giving me the privilege and honor to present my views on Cost Accounting Standards. My dealing with these Standards during both the formative and implementation stages have occupied a considerable part of my professional life during the last 15 years. I hope my views will be helpful during your deliberations regarding new CAS legislation. If I can assist the Committee or the staff in anyway please do not hesitate to call on me.

Chairman ROTH. The committee is in recess.

[Whereupon, at 11:43 a.m., the committee was recessed, to reconvene subject to the call of the Chair.]

ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD

Aerospace Industries Association of America, Inc.

Office of the President

June 15, 1983

The Honorable William V. Roth
Chairman
Committee on Governmental Affairs
United States Senate
356 Dirksen Senate Office Building
Washington, D. C. 20510

Dear Mr. Chairman:

The Aerospace Industries Association of America, Inc. (AIA) appreciates the opportunity to respond to the inquiries contained in your letter of May 13, 1983, dealing with the need to re-establish a fully functioning oversight authority to monitor the Cost Accounting Standards.

As you know, Elmer B. Staats, as Chairman of the Cost Accounting Standards Board, in a letter dated February 9, 1981 to the Director of the Office of Management and Budget, stated that "...this Board has completed its work..." and "...responsibility for administration of the Standards properly lies with the Executive Branch as in the case of other procurement regulations...".

Public Law 91-379, which established the Cost Accounting Standards Board, provides that Cost Accounting Standards have the full force and effect of law. The Act, however, does not authorize any agency other than the Board to grant waivers, exemptions or to clarify Standards. Accordingly, since 1980, when the Congress discontinued the funding of the Board, only Congress has had the power to perform such functions. Should Congress deem it necessary to establish a means for monitoring the existing Standards, since Standards are procurement tools used by the Executive Branch in negotiating and administering Government contracts, we agree with Mr. Staats that maintenance responsibility for the Standards should fall within the purview of the Executive Branch.

As to your specific inquiries:

1) Is there any evidence of a need to oversee the Cost Accounting Standards? Since the demise of the Cost Accounting Standards Board, what problems, if any, have surfaced.

   Response: Experience has demonstrated that, at least in a few cases, clarification of a specific Standard, as well as the granting of waivers and exemptions, would have been beneficial to the procurement process. The problems that have surfaced have been mainly in the administration of the Standards and not the Standards per se.

2) If a fully functioning oversight authority is established, what duties should it perform? How broad should the authority be?

   Response: We have not reached a consensus as to this inquiry.

We shall be pleased to furnish any further information on this matter, should you so desire.

Yours very truly,

Karl G. Harr, Jr.

22-859 O - 83 - 7

ASSOCIATION OF GOVERNMENT ACCOUNTANTS
NATIONAL OFFICE: 727 SOUTH 23rd STREET, SUITE 100, ARLINGTON, VA 22202 (703) 684-6931

Honorable William V. Roth, Jr.
Chairman, Senate Committee on Governmental Affairs
Senate Hart Building 104
Washington, D.C. 20510

Dear Mr. Chairman:

The Association of Government Accountants (AGA) welcomes the opportunity to provide its views on the need for reestablishing a Cost Accounting Standards Board. The AGA is a professional organization of 12,000 members engaged in governmental accounting, auditing, budgeting, and information systems.

Briefly stated, we certainly do favor having authority over Cost Accounting Standards assigned to a new Board or other organization. We're convinced there is a real need for this, as indicated by our responses to the following questions you pose in your letter dated May 11, 1983.

1. Question. Is there evidence of a need to oversee the cost accounting standards? Since the demise of the Cost Accounting Standards Board, what problems, if any, have surfaced?

   The AGA is not in a position to know of specific problems with Standards that have arisen between the Government and contractors. It seems clear to us, however, that no standards or regulations can be left untended for long. In the accounting profession, the FASB and the AICPA are constantly issuing new accounting and auditing standards, and are amending and interpreting existing standards. In the field of Government procurement, authoritative bodies are similarly always updating the cost principles used to determine allowable contract costs.

   Professional standards evolve and then grow from what is learned from the past. Hence, the CAS Board did not take up a task in 1971 and complete it in 1980. It accomplished a step, albeit a major step, in an ongoing process. Someone must be given authority over cost accounting standards so that the evolution can continue.

2. Question. If a fully functioning oversight authority is established what duties should it perform? How broad should its authority be?

   We believe that the new CAS function should have authority to issue new standards, and to interpret and amend existing standards. In short, the new function should have the same authority as did the CAS Board.

Without full authority, all proposals by the new function would be open to the criticism that they are, in substance, new standards. In our view, it is not practicable to distinguish between (i) new standards, and (ii) amendments and interpretations to existing standards. New issues emerging from changing conditions need to be dealt with. It seems illogical to deny the new CAS function the authority to do so.

Thank you again for the invitation to comment on this issue.

W. Fletcher Lutz

W. FLETCHER LUTZ
Executive Vice President

22-859 . 164

THE BOEING COMPANY

P. O. Box 3707
Seattle, Washington 98124

June 15, 1983
1-9100-11-4838

Senator William V. Roth, Jr.
Chairman, Committee on Governmental Affairs
United States Senate
Washington, D.C. 20510

Dear Senator Roth:

On May 27, 1983, The Boeing Company offered its views concerning an oversight authority to monitor Cost Accounting Standards in response to your solicitation to several industry associations. Upon reflection we find our comments to be incomplete with respect to potential methods of implementation. We wish to supplement our statement with the following views.

To assure the independence and credibility of the authority responsible for the use of Cost Accounting Standards in federal procurement, the enabling legislation should provide for a five (5) man Board of experts competent and experienced in cost accounting and representative, respectively, of the Executive Branch Agencies, the Public Accounting Profession, the Academic Accounting Profession, Major Contractors and Small Business Contractors, supported by the ten (10) person staff suggested in our earlier communication.

Also to meet Constitutional question or challenge, we suggest that the Board be located in the Office of the Comptroller General; that the Board have final authority to promulgate rules and regulations, and that the members of the Board, as well as its Chairman, should be appointed by the President.

To assure that Congressional intent is fully and clearly expressed, the legislation should provide that:

- all standards, rules, regulations and interpretations of the Board be consistent with sound accounting principles and provide for accurate, fair and equitable cost determinations;
- the Board review existing standards, rules, etc., for compliance with the above requirement;
- all revised or new promulgations be subject to appropriate notice and opportunity for public review and comment by publication in the Federal Register;
- the Board's rules are mandatory and must be implemented by all relevant agencies.

Sincerely,

Arthur H. Lowell
Controller

Department of Energy
Washington, D.C. 20585

May 17, 1983

William V. Roth, Jr.
Chairman, Committee on Governmental Affairs
United States Senate
Room SD 340
Washington, DC 20510

Dear Chairman:

The Cost Accounting Standards Board (CASB) ceased to exist on September 30, 1980, having completed its task of promulgating the Cost Accounting Standards (CAS). Although the CASB no longer exists, the nineteen standards which they promulgated during the period 1970 to 1980 still have the force and effect of law. The legislation creating CASB limited its coverage to defense contracts, however, all nondefense agencies have implemented the Board's standards and related promulgations as part of their procurement regulations. Consequently, most companies doing business with the Federal Government are affected by CAS.

The impact of CAS goes beyond the need to develop and maintain new accounting systems. CAS can affect companies' profits and resulting capital accumulation and, if their impact is adverse, discourage companies from pursuing Government business, thus weakening the base of suppliers available to satisfy the Government's needs for goods and services.

It is the current environment, where a substantive body of procurement law remains in force with no single authoritative body to issue, amend or interpret CAS, that is of concern to us. Without an organization providing executive oversight, these standards will tend to become too detailed and rigid, with no means for developing workable alternatives.

We consider it to be important, therefore, that some agency be authorized to modify and simplify existing standards, resolve those questions that have arisen or that may arise in the future, grant waivers on individual contracts, approve alternatives to deal with special needs, and report to Congress on the status of actions taken. Without an authority to modify the existing Standards or to clarify the Board's regulations, the promulations of the Board may become inflexible and not serve the best interest of industry, the Government, and the general public.

We recommend that responsibility for CAS be placed in an executive agency. Doing so well make possible the resolution or problems that have arisen during the implementation years and facilitate any modifications made necessary by the dyanamics of changing business and procurement circumstances.

Sincerely yours,

James R. Richards

James R. Richards
Inspector General

Electronic Industries Association

May 24, 1983

The Honorable William V. Roth
Committee on Governmental Affairs
United States Senate
Washington, DC 20510

Dear Senator Roth:

In view of the May 19 testimony before your Committee, in which Mr. William Onsted of the Private Sector Council discussed the advisability of reducing DOD progress payment rates, we feel the enclosed Association statement on the subject might be of interest.

The statement sets forth the view of member companies of EIA that the report on which the recommendation to reduce progress payments was based should be withdrawn. The report emanated from erroneous information, resulting in improper and unsubstantiated conclusions.

We appreciate the willingness of your Committee to consider a broad range of viewpoints in your evaluation of this and other important elements of DOD contract management practices. Our representatives stand ready to provide further information or assistance in this and any related matters, should your so desire.

Yours very truly,

Jean A. Caffiaux
Vice President
Government Division

JAC/rgv

2001 Eye Street, N.W. · Washington, D.C. 20006 · (202) 457-4900 · TWX: 710-822-0148

Electronic Industries Association

May 11, 1983

Mr. J. Peter Grace, Director
President's Private Sector Survey
On Cost Control in the Federal Government
1850 K St., N. W. - Suite 1150
Washington, DC 20006

Dear Mr. Grace:

This letter is in reference to the recommendation regarding Department of Defense Contract Financing contained in the report issued by the Financial Asset Management Task Force of the President's Private Sector Survey on Cost Control in the Federal Government. This task force recommendation was "that DoD scale back progress payment rates to the February 1981 levels of 80 percent for not-small businesses and 85 percent for small businesses. The conditions justifying past increases are no longer present." Many of the 400 member companies of our Association provide electronic products, equipment, systems and services to the Department of Defense. It is on their behalf that we request your reconsideration of this recommendation. We believe that is is imperative for this recommendation to be withdrawn from the report because it emanates from three stated conclusions which are based on erroneously reported facts, information and assumptions.

The first of these conclusions is that "the rationale for raising the progress payments is not longer valid because increased progress payments on fixed price contracts have not led to reduced profit rates." This conclusion is based upon the erroneous assumption that the DoD intent in increasing progress payment rates was to reduce profit rates. The actual facts are to the contrary. The initial five percent increase in the progress payment rates promulgated in March 1981 was a belated and extremely conservative attempt by the DoD to arrest the constant erosion of actual realized defense industry profits caused by the increasing level of interest rates. The progress payment rate of 80 percent was established in 1968 when interest rates approximated six percent, interest cost of money was unallowable for government contract purposes, and the weighted guidelines for deriving negotiated contract profits gave no explicit recognition of cost of money levels. In 1981, and to this point in time, the interest cost of working capital is still unallowable as a contract cost and the profit weighted guidelines still do not address cost of working capital. However the interest cost of working capital to contractors has risen in recent years to unprecedented levels and appears unlikely to recede to a level of six percent in the foreseeable future.

(more)

2001 Eye Street, N.W. · Washington, D.C. 20006 · 202-457-4900 · TWX:710 822-0148

Accordingly, the DoD sought a means of alleviating the resultant profit loss on the part of defense contractors. Proposals to directly increase profit rates were rejected because the effect of such an increase would have taken too long and because such action would have increased the cost to the taxpayer due to the fact that the government can borrow funds at more favorable rates than industry. Action to increase progress payment rates was taken because it avoided the above stated negative aspects of increasing profit rates, it provided working capital funds to those companies that found it difficult to acquire borrowings, and it provided the the opportunities for contractors to transfer their funds from working capital to investments in cost-reducing plant and equipment capital assets.

Furthermore, relative to this first conclusion, the profit rates shown in Table II-3 are not factual beyond 1979 because OSD has neither compiled nor estimated these data beyond that date. Also, the profit data reflected in the table do not represent actual realized contract profit but merely government contracting officers' opinion as to the going-in negotiated profit rate applied to a cost base of less than full contractor costs, due to unallowables. Thus the profit data, even if correct, are not valid as a measure of realized contractor profits which, in practice are often substantially less than the going-in negotiated profit.

The second reported conclusion on this issue is that "facilities capital cost of money is now an allowable cost for progress payments, negating the justification for the first increase in March 1981." This conclusion is based on two erroneous elements of information. The report states in one place that facilities capital cost of money was recognized as an allowable incurred cost for progress payments in December 1981 and in another place that it was recognized in between the seven months, March to October 1981. The true fact is that such recognition was promulgated by the DoD in Defense Procurement Circular (DPC) 76-3 in September 1976. The intent of DPC 76-3 was not related to progress payments but instead to incentivizing contractors to invest in cost-reducing facilities and equipment. The second erroneous element of information is that even if the facilities cost of money had not been recognized as a cost before December 1981, its impact on profits would equate to a five percent increase in the progress payment rate. Even using the hypothetical and non-relevant profit rates shown in Table II-3, the difference in progress payments at 80 percent on all fixed price type contracts approximates only a 1.8 percent increase, not five percent.

The third and final conclusion in the report is that "interest rates have fallen substantially since October 1981 when the prime rate was 20.5 percent to 12.5 percent, thereby negating the reasoning for the second increase." This conclusion is based on the incorrect assumption that the second increase, from 85 to to 90 percent, was predicated on the necessity to alleviate the affect on defense contractors of high level interest rates. The real reason for this rate adjustment was to offset the effect of the change from bi-weekly to monthly of contractor progress payment billings. DoD analyses in 1981 indicated that a payment of 90 percent of qualified costs made to a contractor once per month was roughly equivalent to a payment of 85 percent made twice per month. The net effect of the March 1981 change was to leave the relative level of progress payments unchanged while reducing governmental administrative paperwork by approximately 50 percent.

(more)

Interest rates were not a factor in the decision. The statement in the conclusion that the prime interest rate has fallen to 12.5 percent is correct. However, it should be noted that that rate is double the level of the six percent prime interest rate that existed at the time of the establishment of the 80 percent progress payment rate in 1968.

In summary, the majority of the relevant facts set forth in the referenced report is erroneous thus leading the committee members to improper conclusions in support of their recommendation. Accordingly, we urge you to withdraw this recommendation. Members of this Association would be pleased to discuss this issue, and our response, with you or your committee members at your convenience.

Sincerely,

Jean A. Caffiaux
Vice President
Government Division

JAC/rgv

cc: Mr. Bruce Fielding
President
Fielding, Lockley & Strek
1043 Stierlin Road, Suite 201
Mountain View, CA 94043

NASA
National Aeronautics and
Space Administration

Washington, D.C.
20546

Reply to Attn of: Inspector General

Ms. Terry Jolly
Chief Clerk of the Committee
on Governmental Affairs
Dirksen Senate Office Building
Room SD-346
Washington, D.C. 20510

Dear Ms. Jolly:

The following comments are submitted in response to Senator Roth's letter of May 11, 1983, regarding the need to re-establish a fully-functioning oversight authority to monitor cost accounting standards.

1) Is there evidence of a need to oversee the cost accounting standards? Since the demise of the Cost Accounting Standards Board, what problems, if any, have surfaced?

There is a need for an oversight authority to administer the standards, rules and regulations promulgated by the former Cost Accounting Standards Board. My office has identified at least two examples in NASA where such an authority would have been helpful in resolving issues relating to the cost accounting standards. Summary information on these examples is contained in Attachments A and B. One example shows the need for a revision or further clarification of Cost Accounting Standard 410, Allocation of Business Unit General and Administrative Expense to Final Cost Objectives, and the other example shows the need for an authoritative source to grant waivers from the cost accounting standards.

The cost accounting standards, rules and regulations should be evaluated on a continuing basis to ensure their effectiveness and currency. New promulgations should be issued and existing ones amended as circumstances change or new situations arise. The cost accounting standards should be reviewed in light of actual experience, including Board of Contract Appeals and Court of Claims decisions.

The establishment of a single expert authority to issue interpretations would promote a major objective of the cost accounting standards; that is, to achieve an increased degree of uniformity

in cost accounting practices among Government contractors in like cirucumstances. Particularly in those cases where an issue is widespread and serious, a single expert authority to issue interpretations of existing promulgations is more desirable than resolving the issue on an ad hoc basis by the procuring agencies and their appeals boards.

2) If a fully-functioning oversight authority is established, what duties should it perform? How broad should its authority be?

A fully-functioning oversight function should have the authority to (1) promulgate new standards, rules and regulations for the proper and consistent accounting treatment of costs under Government contracts; (2) amend and interpret existing standards, rules and regulations; and (3) grant waivers and exemptions. The oversight authority should serve as an authoritative source for both contractors and Government agencies.

If you have any questions regarding this matter, please call Mrs. Sharon Connelly, Assistant Inspector General for Auditing, at 755-3555.

Sincerely,

June Gibbs Brown
Inspector General

Attachments

Attachment A

COST ACCOUNTING STANDARD 410 ALLOCATION OF BUSINESS UNIT GENERAL AND ADMINISTRATIVE EXPENSES TO FINAL COST OBJECTIVES

Implementation of Cost Accounting Standard (CAS) 410, Allocation of Business Unit General and Administrative Expenses to Final Cost Objectives, has caused several significant disagreements between the Government and contractors over the proper base to be used in allocating these expenses. (CAS 410 provides that the measure of cost input best representing the total activity of the business unit during a cost accounting period is to be selected as the base.) Such disagreements exist notwithstanding the issuance of a related DoD CAS Steering Committee guidance paper, which was endorsed by the CAS Board. For example, at one major NASA contractor location, the cognizant DoD Administrative Contracting Officer (ACO) in March 1978 supported a Defense Contract Audit Agency (DCAA) audit recommendation and made a determination that the contractor's use of a single element direct labor dollar base to allocate general and administrative expenses was in noncompliance with CAS 410. In substance, the ACO concluded that the contractor's single element base did not best represent the total activity of the business unit.

In February 1979, the DoD-ACO reversed the prior determination of noncompliance. Because of a difference of opinion on this matter between the local DCAA auditor and the DoD-ACO, it was referred to higher levels of DoD and NASA management for further consideration. In April 1980, the cognizant DoD-ACO again determined that the contractor was in noncompliance with CAS 410. In October 1980, the DoD-ACO disagreed with the contractor's appeal to the determination of noncompliance. DCAA estimated that the excess cost to the Government attributable to the noncompliance through 1981 is $15.4 million.

After a period of five years, this matter still has not been resolved. It is currently in dispute, and hearings have been held by the Armed Services Board of Contract Appeals. Such disagreements illustrate the need for an oversight function with requisite authority similar to that held by the former CAS Board. This CAS 410 and other standards need to be reviewed in light of actual experience, including Board of Contract Appeals and Court of Claims decisions. Upon completion of such reviews, the CAS should then be revised or interpretations issued in order to avoid or minimize disagreements.

Attachment B

NEED FOR AUTHORITATIVE SOURCE TO GRANT WAIVERS FROM COST ACCOUNTING STANDARDS

A subcontractor to one of NASA's major prime contractors refused to accept the provisions of the Cost Accounting Standards (CAS) in its subcontract. Although there was one other source for a critical item needed from this subcontractor, NASA concluded that neither of the potential suppliers alone could meet the estimated increase in requirements to support the NASA Shuttle program, nor could an additional new supplier be qualified in time to meet the Shuttle launch schedule. The subcontractor, prior to this acquisition, was not subject to the requirements of the CAS and, in view of its relatively small percentage of estimated Government sales (one percent) to its overall total corporate sales, the subcontractor simply refused to accept the CAS provisions.

The authority to waive CAS requirements was vested by statute (50 U.S.C. App. 2168(h)(2) (1976)) in the Cost Accounting Standards Board; however, the Board discontinued its operations at the close of fiscal year 1980. Although the requirements of the standards, rules and regulations promulgated by the CAS Board remained in effect, there had been no designation of an alternate waiver authority as of the time action was required to procure the critical item required to support the Space Shuttle launch schedule. Therefore, in the absence of a successor to the CAS Board, NASA used the authority of P.L. 85-804 (Extraordinary Contractual Adjustment Procedures) to waive the CAS requirements for this critical acquisition. Legal counsel of NASA and the U.S. General Accounting Office (GAO) have concluded that the NASA Administrator has such waiver authority under P.L. 85-804.

P.L. 85-804 empowers the President to authorize Departments and agencies to enter into contracts, including amendments or modifications, without regard to other provisions of the law relating to contracting, in order to facilitate the national defense. According to a representative of GAO, this was the first instance where the authority granted under P.L. 85-804 was used to waive the CAS requirements. The establishment of a CAS oversight function with waiver authority similar to that previously held by the CAS Board would avoid the need to use the broad powers granted by Congress under P.L. 85-804 to grant this type of waiver.

NATIONAL SECURITY INDUSTRIAL ASSOCIATION
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L.J. Adams
Chairman,
Board of Trustees
H.B. Smith
Vice Chairman
Board of Trustees
Chairman,
Executive Committee
R.W. Clark
Vice Chairman,
Executive Committee
W.H. Robinson, Jr.
President

The Honorable
William V. Roth, Jr.
Chairman, Committee on
Governmental Affairs
United States Senate
Washington, DC 20510

Dear Mr. Chairman:

We thank you for your letter of May 13, 1983, asking the views of the National Security Industrial Association (NSIA) "concerning the need to reestablish a fully functioning oversight authority to monitor the cost accounting standards."

As you are undoubtedly aware, this Association has always demonstrated and has a keen interest in the cost accounting standards. Any possible action by the Senate pertaining to the assignment of some of the functions of the now defunct Cost Accounting Standards Board to another Government agency is important, because the cost accounting standards are an important procurement tool used by the Executive Branch of Government in negotiating and administering Government contracts.

Industry and Government have now operated under cost accounting standards, as issued, for a number of years and adjustments have been made to comply with the standards. However, this means that each industrial company has adjusted its unique accounting system to handle its problems, wherever needed.

The NSIA Procurement Committee, consisting of experts in the field of Government procurement, has held several meetings in the last four weeks in an effort to reach agreement on a proper and complete reply to your letter. The conclusion reached is that an in-depth survey and discussion is required before we can respond to your questions and that we have been unable to do that in the time available in view of the variety and complexities of the issues. We recommend that the appropriate committee in the Senate conduct in-depth hearings into the question of assignment of functions of the Cost Accounting Standards Board to another Government agency, and that industry be requested to participate fully in these hearings in an effort to provide to the Senate the well thought out and thoroughly reviewed recommendations of the entire involved industrial community - all products and services, and company sizes. This would provide an opportunity to explore the alternatives available in an effort to achieve what we are sure to be the objectives of both Government and industry.

Sincerely,

Wallace H. Robinson, Jr.
President

WHR/ad

WILLIAM V. ROTH, JR., DEL., CHAIRMAN
CHARLES H. PERCY, ILL.
TED STEVENS, ALASKA
CHARLES MC C. MATHIAS, JR., MD.
WILLIAM S. COHEN, MAINE
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IRA S. SHAPIRO, MINORITY STAFF DIRECTOR

United States Senate
COMMITTEE ON
GOVERNMENTAL AFFAIRS
WASHINGTON, D.C. 20510

July 11, 1983

The Honorable Caspar W. Weinberger
Secretary of Defense
Room 3E880
The Pentagon
Washington, D. C. 20301

Dear Cap:

The Committee on Governmental Affairs conducted the third in this year's series of Department of Defense (DoD) management oversight hearings on May 19, 1983. In that hearing we examined some existing problems in the Department's cash management policies regarding progress payment rates and reimbursements to contractors for accrued vacation expenses and some potential problems regarding the Department's acquisition improvement (Carlucci) initiative to amend or repeal CAS 409 so contractors can depreciate capital assets faster.

I recognize the importance of maintaining a strong, highly productive Defense industrial base and understand that in the absence of a fully competitive marketplace DoD acquisition policies should provide sufficient contractual incentives to achieve that objective insofar as practicable. Obviously, when adopting such policies the full cost of the contractual incentive should be considered as well as the expected improvements in contractor performance. It is with respect to the cost/benefit relationships of these policies and their expected results that the actions of the Defense Department appear questionable and need to be critically and objectively reviewed.

The findings of three highly qualified witnesses (summarized in the enclosure) suggest that these policies could be very, very costly and may not achieve the desired objectives. Further, the witnesses indicate that they found no evidence that DoD officials had made any substantial analyses or studies, either before or after implementation, to determine the impact of these policies on Defense Department cash outlays,related increases in Treasury Department interest expense and weapon system cost growth.

Despite the assurances made by your Deputy Under Secretary for Acquisition Management at the hearing, I want to bring this matter to your personal attention because of the criticisms of the DoD policies offered by other witnesses, the absence of pre-implementation cost/benefit analyses by DoD officials, the still uncertain status of the DoD acquisition policy encouraging contractors to use shorter depreciation periods for certain assets, and the magnitude of the potential additional costs on defense contracts that could result from the DoD policies discussed during the hearing.

Further, I am also suggesting, in the enclosure, that the Defense Department take several actions which I believe will (i) lead to improved cash management practices and (ii) assure that DoD contracting officers and outside critics alike understand that DoD has decided not to pursue repeal or amendment of CAS 409. In addition, the proposed actions will assure that the December 20, 1982 OSD memorandum sent as guidance to DoD contracting officers concerning the contractual application of faster write-offs of depreciaton will be used judiciously and not as a means of violating the provisions of CAS 409.

Please keep me advised of the Department's progress in resolving these matters. I look forward to hearing from you soon.

Sincerely,

Bill Roth

William V. Roth, Jr.
Chairman

WVR:smh

Enclosures

Summarizations of Witnesses' Findings Concerning Reimbursements for Accrued Vacation Costs, Progress Payment Rates and Depreciation of Capital Assets (As Disclosed in the Cost Accounting Standards Hearing)

I. Accrued Vacation Costs

A. Finding:

Testimony by Mr. Derek J. Vander Schaaf, the DoD Deputy Inspector General revealed that a one-time reduction of up to $2 billion in cash outlays might be achieved by deferring the payments for accrued employee vacation expenses to more closely approximate the contractors' actual disbursements of these accrued expenses. An adjustment of this nature in DoD's progress payment practices could also reduce Government interest costs by about $140 million each year.

The suggestion, according to Mr. Vander Schaaf, was not in conflict with established Cost Accounting Standards (CAS). The applicable standard, CAS 408 - Accounting for Costs of Compensated Personnel Absence, provides uniformity in the measurement of costs of vacations, but does not call for the reimbursement of accrued vacation expenses irrespective of the contractors' actual disbursements. As Mr. Vander Schaaf pointed out at the hearing, his suggested deferral of accrued leave reimbursements is not a totally new concept. Reimbursements are often deferred. For example, reimbursements for material costs are based on the movement of the material to contract work-in-process rather than the earlier date of purchase or receipt. Ms. Mary Ann Gilleece, the DoD Deputy Under Secretary for Acquisition Management, stated that contractors would have to incur additional administrative costs and argued that the adjustment in reimbursement practices was contrary to the provisions of CAS 408 and would unnecessarily disrupt longstanding DoD practices on which contractors rely.

B. Suggestion:

Have a cost/benefit study made as soon as possible to establish with a reasonable degree of reliability the impact of acting on Mr. Vander Schaaf's recommendation and, if the results of the study show that such an action would be beneficial to the Government, revise applicable DoD acquisition procedures and practices accordingly.

II. Progress Payment Rates

A. Finding:

Mr. William G. Onsted, President of the Private Sector Council, Washington, D.C., while serving as the chairman of the Financial Asset Management Task Force on the "Grace Commission" found that DOD had increased progress payment rates (i) in March 1981, from 80 to 85% for not-small contractors and from 85 to 90% for small contractors, apparently to compensate for the high cost of borrowing and (ii) in October 1981, from 85 to 90% for not-small contractors and from 90 to 95 for small contractors, apparently to compensate for increasing reimbursement base periods from bi-weekly to monthly. Concurrently with the second rate increase, DOD adopted a "flexible" progress payment procedure enabling contractors to obtain up to 100% of incurred costs on applicable negotiated contracts.

Mr. Onsted's Task Force report indicated that the increased rates were no longer justified because interest rates had declined about 50% since March 1981, and recommended that the progress payment rates be returned to the pre-March 1981 levels. The report, which has not yet been officially approved by the Grace Commission, showed that the scale back in progress payment rates could result in one-time cost reduction of about $5 billion in cash outlays plus a reduction in the Government's annual interest costs on this amount totaling several hundred million dollars.

Ms. Gilleece testified that the Task Force's facts and conclusions were in error, and stated that there was no urgency to reduce progress payment rates since current borrowing rates were still considerably higher than the 6 to 7% levels in effect before the March 1981 increases were adopted.

Mr. Onsted advised the Committee that DOD did not conduct a study to determine the impact on cash flow before or after revising the progress payment rates.

B. Suggestion:

Have a study conducted to (i) obtain a realistic estimate of the impact of increased progress payment rates on DOD cash flow and Government interest costs, (ii) ascertain with some precision the pertinent circumstances that existed when the rates were increased in March and October, 1981. Progress payment rates should be lowered to the proper levels to obtain the cash outlay savings that are available through good cash management practices based on the findings of these studies.

III. Depreciation of Tangible Capital Assets

A. Finding:

Mr. Clark Adams, Group Director in the General Accounting Office (GAO) Procurement, Logistics and Readiness Division, testified regarding his concerns about the possible impact of (i) Carlucci Initiative 5a which calls for repealing or amending CAS 409 to permit more rapid depreciation of capital equipment and to recognize replacement inflation depreciation costs and (ii) extensive authorization of rapid depreciation practices on Defense contracts that could result from Dr. DeLauer's memorandum of December 20, 1982 encouraging DOD contracting officers to use the latitude already provided in the provisions of CAS 409 to enter into contractual agreements authorizing shorter depreciation periods on certain assets. Mr. Adams believed, and Mr. Vander Schaaf concurred with him, that this DOD guidance placed in prime focus what is essentially an exception provision of CAS 409. Failure on the part of the Air Force and Defense Logistics Agency to issue implementing instructions could be an indication that they too are concerned about the possibility of the wide spread application of Dr. DeLauer's memo.

Ms. Gilleece confirmed at the hearing the information provided by DOD to the Committee's prehearing questions. DOD does not intend to pursue repeal or amendment of CAS 409, nor does DOD desire to use asset replacement value for determining depreciation cost. Although this position indicates a reversal of previously stated DOD policies, the new position had not been publicly announced prior to the hearing. An informal memo between two USDR&E employees indicated that no further action to amend or revoke CAS 409 was necessary because CAS 409.50(e)(5), which Dr. DeLauer cited in his December 20, 1982 memorandum, provided for advance agreements on shorter service lives than would otherwise be determined under the standard. But the internal USDR&E memo is not a public repudiation of existing DOD policy as expressed in Carlucci Initiative 5a.

Despite the confusion caused by the absence of a formal announcement that DOD was abandoning the goals identified by Carlucci Initiative 5a and the issuance of the December 20, 1982 memorandum, Ms. Gilleece did not think it was necessary to issue clarifying policy guidance to DOD contracting officers. Mr. Adams recommended that such an action be taken rather than leaving the interpretation and extent of application of the memorandum to chance.

Based on GAO's preliminary findings, if rapid depreciation agreements are widely used, the cost of DOD weapon systems could increase by several billion dollars annually.

B. Suggestion:

Issue a DOD policy announcement to all DOD components that DOD is abandoning the stated objective of Carlucci Initiative 5a (i.e. will not pursue repeal or amendment of CAS 409). Further, issue supplementary instructions to the addressees of Dr. DeLauer's December 20, 1982 memorandum to assure that the application of CAS 409.50(e)(5) is strictly limited to truely unique circumstances, and should not be used as a means to circumvent the use of generally accepted depreciation rates.

AIR FORCE SYSTEMS COMMAND--PROFIT STUDY 1982

SUMMARY REPORT

FOREWORD

On 13 May 1975, the Deputy Secretary of Defense initiated a major Department of Defense (DOD) study of profit and its relationship to capital investment and increased productivity. This 16-month study, known as Profit '76, identified a strong correlation between the then existing DOD profit policy and low levels of capital investment within the defense industry. As a result, DOD undertook several policy revisions with the long-range goal of achieving increased productivity. These revisions were promulgated in Defense Procurement Circular (DPC) 76-3 in September 1976, and except for a mid-course correction published in Defense Acquisition Circular (DAC) 76-23 in February 1980, they have served as the current profit policy.

A procurement personnel opinion survey conducted during Profit '76 disclosed that there was strong sentiment for change. Of 200 personnel surveyed, 53% felt that the DOD should revise its profit policies versus 26% who did not. We found that, in spite of the profit policy revisions which emanated from Profit '76, the sentiment for change is just as strong today. A comparable survey of 170 Air Force Systems Command (AFSC) acquisition personnel conducted in 1982 revealed that 62% still favored major revisions to the current profit policy versus 19% who did not. Other indications of this prevailing attitude were highly visible in professional literature, research studies, industry symposiums, and in the general conduct of defense contracting. On one thing both industry and large portions of government seem to be in complete agreement: although DPC 76-3 and DAC 76-23 were steps in the right direction, the total reformation needed has been incomplete.

It was against this backdrop that AFSC's Deputy Chief of Staff/Contracting & Manufacturing initiated a similar study to examine the continued relevance of the current profit policy in today's business environment. The objective was not to validate the findings of Profit '76 but rather to assess how well DPC 76-3 and DAC 76-23 have worked. The specific criticisms of the current profit policy were reviewed within the framework of empirical data which would either support or disprove such claims. The ultimate goal of AFSC's Profit Study '82 was to develop sustainable findings on key problem areas and recommend profit policy improvements, where warranted. The AFSC Profit Study '82 was performed in support of the Defense Acquisition Improvement Program and AFSC's Project Cost.

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ACKNOWLEDGMENTS

We are very grateful to the many people who made significant contributions to the AFSC Profit Study '82. Particularly noteworthy was the support that we received from Mr. Beaddle of the Air Force Data Service Center and Mr. Shenk and Ms. Springer from the DOD Directorate for Information Operations and Reports and Ms. Higel from the AFSC Command Library Division. We are also thankful for the earnest contributions of the AFSC contracting activities, especially those who participated in the Acquisition Personnel Opinion Survey. Special recognition is accorded to the 12-member Blue Ribbon Panel of representatives from government and industry who significantly contributed to the AFSC Profit Study '82.

TABLE OF CONTENTS

	PAGE
FOREWORD	i
AFSC PROFIT STUDY '82 EVALUATION TEAM	iii
ACKNOWLEDGEMENTS	iii
TABLE OF CONTENTS	vii
TABLE OF EXHIBITS	viii
EXECUTIVE SUMMARY	xi
PART I: AFSC PROFIT STUDY: PURPOSE AND SCOPE	1
PART II: CURRENT PROFIT POLICY	5
PART III: PROFITABILITY 1977-1981	13
PART IV: PROFIT AND CAPITAL INVESTMENT	31
PART V: PROFIT AND PRODUCTIVITY	45
PART VI: OTHER PROFIT RELATED PROBLEMS	49
PART VII: FINDINGS AND RECOMMENDATIONS	53
REFERENCES	61
BIBLIOGRAPHY	62
APPENDIX A: Selected Literature Abstracts	65
APPENDIX B: AFSC Acquisition Personnel Opinion Survey	81

TABLE OF EXHIBITS

EXHIBIT		PAGE
1	Return on Sales, 1970-1974	6
2	Negotiated vs Realized Profits of Government Profit Centers, 1970-1974	6
3	Return on Investment, 1970-1974	7
4	Assets/Sales, 1970-1974	7
5	Summary of Profit Policy Changes	10
6	Realized Profit Performance, FTC Durable Goods Producers, 1977-1981	13
7	Negotiated Profit on AFSC Contracts, 1977-1981	14
8	Comparative Analysis of Operating Profit, 15 Selected Top Aerospace Contractors, 1979 and 1981	15
9	Desired Redistribution of Profit Factors	16
10	Distribution of Negotiated Profit Factors on AFSC Contracts, 1977-1981	17
11	Distribution of Profit Factors, By Contract Type, 1977-1981	18
12	Profit Objective on DOD Contracts, 1975	19
13	Comparative Baseline to DPC 76-3 Profit Policy Revisions	20
14	Profit Objectives on AFSC Contracts, Analysis of Differences from Baseline, 1977-1981	21
15	Profit Objective on AFSC Contracts, By Contract Type, 1977-1981	22
16	Distribution of Mean Profit Objectives, 1975	23
17	Distribution of Mean Profit Objectives, 1977-1981	25
18	DPC 76-3 Changes in Risk Factors	26
19	DAC 76-23 Changes in Risk Factors	27

EXHIBIT		PAGE
20	Net Book Value of Tangible Capital Assets, 1978-1982	32
21	New Plant and Equipment Expenditures, 1977-1982	33
22	Comparative Analyses of Defense Related Business Segments, 1981	34
23	Cost of Money on AFSC Contracts, 1977-1981	37
24	Capital Employed Profit on AFSC Contracts, 1977-1981	38
25	Allocated vs Recognized Capital Employed on AFSC Contracts, 1977-1981	38
26	Allocated vs Recognized Capital Employed, By Contract Type, 1980-1981	39
27	Direct Labor vs Capital Employed on AFSC Contracts, 1977-1981	39
28	Discounted Cash Flow Analysis	47
29	Impact of Time Value of Money on Profit	49

EXECUTIVE SUMMARY

On 13 May 1975, the Deputy Secretary of Defense initiated a major DOD study of profit and its relationship to capital investment and increased productivity. This 16-month study, known as Profit '76, identified a strong correlation between the then existing DOD profit policy and low levels of capital investment within the defense industry. As a result, DOD undertook several policy revisions with the long-range goal of achieving increased productivity. These revisions were promulgated in DPC 76-3 in September 1976, and except for a mid-course correction published in DAC 76-23 in February 1980, they have served as the current profit policy.

PURPOSE AND SCOPE OF STUDY

The principal thrust of AFSC Profit Study '82 was to review the continued relevance of the profit policy in today's business environment and determine whether the desired goals underlying the profit policy revisions of DPC 76-3 and DAC 76-23 were achieved. Specific objectives of the AFSC Profit Study '82 were as follows:

- Has the profit policy stimulated investment in contractor facilities capital within the defense industry?
- Has the profit policy rewarded productivity improvements generated by defense contractors?
- Has the profit policy fostered a reasonable level of interest in defense contracts?
- Has the profit policy been understood by government and industry?

The AFSC Profit Study '82 could match neither the size nor scope of the Profit '76 study because of limited personnel resources and unavailability of financial data at the profit center level. It was, therefore, necessary to modify our study approach to compensate for such limitations by employing the following steps:

- Solicit comments from AFSC contracting offices and industry associations on profit policy problems and suggested improvements.
- Perform literature review of all pertinent articles, research studies, special reports, etc., which have been published since 1976.
- Duplicate analyses performed in Profit '76 to maximum extent practical.
- Perform additional analyses and tests which were more directly focused on specific profit policy problems.

A preliminary draft of the AFSC Profit Study '82 summary report was sent to a 12-member Blue Ribbon Panel for comment. The Blue Ribbon Panel was

comprised of 6 representatives each from government and industry (see page iii). Panelists were asked independently to critique the study's findings and recommendations. We have modified the summary report to incorporate suggested improvements, where considered appropriate.

CURRENT PROFIT POLICY

Although Profit '76 included several tests of trends, opinions, etc., the pivotal analysis was a comparative study of the differences in profitability between government and commercial business. The profit statistics of defense related profit centers were compared to profit statistics on durable goods producers published by the Federal Trade Commission (FTC). The key findings of the Profit '76 study team were as follows:

- The pre-tax return on sales ratio of realized profits was higher for the FTC durable goods producers than government profit centers.

- The pre-tax return on sales actually realized on government contracts was significantly less (approximately 46%) than the profit rate negotiated by contracting officers.

- The pre-tax return on investment for government profit centers was higher than that achieved by FTC durable goods producers.

- Finally, the amount of capital investment per sales was higher for FTC durable goods producers than for government profit centers.

The Profit '76 study group concluded that government contractors were able to maintain a high return on investment by keeping investment low. They recommended that the profit policy be revised to allow higher return on sales which, in turn, would stimulate capital investment. The desired result was to produce results similar to the FTC durable goods producers and, thus, achieve lower unit costs.

The recommended profit revisions of Profit '76 were promulgated in DPC 76-3 in September 1976. The most important revisions were as follows:

- The emphasis on Contractor Input to Total Performance (CITP), a measure of contractor effort under the Weighted Guidelines, was reduced from 65% to 50% of profit.

- The emphasis on Contract Cost Risk was increased from 30% to 40% of profit. In general, the relative profit range on fixed-price type contracts was increased.

- A new factor, Contractor Investment in Facilities Capital (capital employed factor), was added to the Weighted Guidelines and represented 10% of profit.

- The implicit recognition of cost of money on facilities capital was removed from profit and explicitly recognized as a contract cost under Cost Accounting Standard (CAS) 414, "Cost of Money as an Element of the Cost of Facilities Capital."

- A Special Productivity Factor was added to the Weighted Guidelines to return the lost profit opportunity caused by productivity increases which lower the cost base.

- Because the relative weights of individual profit factors under the Weighted Guidelines format remained unchanged, a 30% degradation of CITP was created so that these profit policy revisions would not result in an overall increase in price to the government.

In February 1980, the profit policy was again revised, principally for the purpose of a mid-course correction. The underlying rationale for this change was based on DOD's examination of the practical experience with DPC 76-3. Three policy revisions were undertaken:

- The range of profit factors for capital employed was increased from 6%-10% to 16%-20%. This would increase this factor's percentage of total profit from 10% to 17%.

- The Weighted Guidelines were modified to provide separate profit weight ranges for manufacturing, R&D, and service contracts. For R&D and service contracts, capital employed was eliminated as a profit factor and CAS 414 cost of money was to be offset dollar-for-dollar.

- The risk factors among contract types were significantly changed to separate factors for cost and multiple incentives.

PROFITABILITY 1977-1981

The profit performance among the FTC durable goods producers, as measured by return on sales, had remained relatively unchanged since Profit '76. During this same period, however, the return on sales which were negotiated on defense contracts had increased from 8.8% to 10.6% (about 20% increase). Our analysis revealed that these increases on defense contracts were not attributable to DPC 76-3. They were almost totally due to changes in contract type mix, contract cost mix, and higher factors being applied by contracting officers. We observed that these increases in defense profits would have occurred even if there had been no change in DOD profit policy.

The Profit '76 study team had concluded that DOD should construct a policy which would provide profit comparability between defense contracts and the commercial sector. Our examination of a number of key indicators disclosed that such comparability was most likely achieved for the 1977-1981 period. Notwithstanding the specific causes for profit increases, we were confident that the gap in realized profit between defense contracts and FTC durable goods producers has significantly decreased.

The desired relative distribution among profit factors (i.e., CITP, risk, capital employed) was not achieved. This was principally caused by the dynamics within the contracting environment such as contract type, cost mix, etc., which have perceptively changed since 1976. For example, the increases in fixed-price type contracts would shift distribution of profit from CITP to risk. The capital employed factor was approximately the 10% desired under DPC 76-3, but was significantly less than the 17% desired under DAC 76-23.

The CITP profit factors on individual cost elements have remained unchanged since the inception of the Weighted Guidelines method in 1964. There was strong evidence which suggests that they are no longer relevant to today's contracting environment. For example, the 1-4% factor for material is probably too low, and the 6-8% factor for G&A is too high.

The Profit '76 study team developed a policy which was designed to provide greater distinction in realized profits between fixed-price and cost type contracts. The profit factors for risk were changed under DPC 76-3 and again under DAC 76-23. Our review disclosed, however, that not much profit distinction was actually achieved as a result of these specific changes. If any distinction was achieved from DAC 76-23, it was a result of now treating R&D and service contracts with profit guidelines similar to those which existed prior to Profit '76. It is very important to note, however, that the 5% profit factor for past performance was not reinstated on such contracts. It was also apparent that the many changes in DOD's profit policy toward risk have caused much confusion for field contracting offices.

PROFIT AND CAPITAL INVESTMENT

Our study revealed that capital investment within the defense industry has increased. Yet, we also found that such investment was still proportionately less than that attained in the commercial sector. This was most evident for those major corporations simultaneously engaged in both defense and commercial business.

Overall, we concluded that profit, in and of itself, will not induce capital investment. In spite of the DPC 76-3 revisions emanating from the Profit '76 study, capital investment as a percentage of total cost did not change during the 1977-1981 period. Thus, the assumption that higher return on sales will stimulate investment on defense contracts was not supported by actual experience. Profits were higher during 1977-1981, but relative investment did not change.

The concept of DPC 76-3 was generally sound in that, all things being equal, profits would increase only if capital investment increased. The structure designed to achieve this concept, however, was flawed. The capital employed profit factor was far too small, and the method of establishing capital employed on a given contract was too indirect. The problems with DPC 76-3 were further aggravated by DAC 76-23, which has resulted in only 60% of the assets assignable to defense contracts being recognized for cost of money and capital employed profit in 1981. Unless rescinded, DAC 76-23 will become a greater obstacle to capital investment.

There have been a number of alternatives suggested to provide a more direct simulus between profit and investment. Many have advocated a return on investment approach. While this approach is conceptually attractive, there are major practical problems (e.g., determination of actual capital used on a given contract). Other alternatives are available which deserve consideration, but there must be a recognition that these should be combined with other capital investment incentives outside the profit policy.

PROFIT AND PRODUCTIVITY

The special productivity factor was created to remove a major disincentive for productivity enhancements by the defense industry: lost profit. Yet, this factor has not been used, except for a few cases. The reason for its disuse does not lie in the DAR coverage but, rather, in its practical application. The difficulty in measuring productivity is the heart of the problem. However, there are other significant practical problems, as well. The factor has been regarded as applying only to the instant contract, even though the productivity increase will provide benefits well into the future. Furthermore, industry does not perceive a genuine interest by the government to use the factor.

The special productivity factor needs to be revitalized as a contracting tool. It is highly compatible with other DOD initiatives such as TECH MOD, shared savings agreements, Value Engineering, etc.

OTHER PROFIT RELATED PROBLEMS

Inflation may have a large impact on profit because of timing differences inherent in the methods of computing and paying profit. This may be particularly serious for long-term fixed-price type contracts.

There was a strong sentiment that the Weighted Guidelines method of computing profit has become very confusing. One of the most confusing elements is the provision for offsetting the cost of money. In addition, ASPM 1 has not kept pace with the profit policy changes.

Finally, both industry and government believed that the Weighted Guidelines method has lost credibility. They believed that profit objectives were significantly influenced by factors outside the Weighted Guidelines method. The most frequently cited influence was management direction. These perceptions, whether real or imagined must be corrected as a priority measure. The credibility of any DOD policy designed to encourage capital investment or induce productivity is entirely dependent upon its perception by contracting officers and industry.

FINDINGS AND RECOMMENDATIONS

Specific findings and recommendations are contained in Part VII of this summary report.

PART I

AFSC PROFIT STUDY '82: PURPOSE AND SCOPE

The principal thrust of the study was to review the continued relevance of the profit policy in today's business environment. We were also interested in determining whether the desired objectives underlying the profit policy revisions of DPC 76-3 and DAC 76-23 were achieved.

STUDY OBJECTIVES

There have been many areas within the current profit policy where deficiencies were purported to exist. These ranged from industry-wide problems to areas which affect only a select segment of industry (e.g., award fee contracts, foreign military sales, etc.) to those affecting the defense industry as a whole. While there was no doubt of industry and government concern with all of these problems, it was necessary to limit our study to subjects of broad interest. Therefore, the objectives of the AFSC Profit Study '82 were limited as follows:

- Has the profit policy stimulated investment in contractor facilities capital within the defense industry?
- Has the profit policy rewarded productivity improvements generated by defense contractors?
- Has the profit policy fostered a reasonable level of interest in defense contracts?
- Has the profit policy been understood by government and industry?

STUDY APPROACH

The AFSC Profit Study '82 could match neither the size nor scope of the Profit '76 study because of limited personnel resources and unavailability of financial data at the profit center level. It was, therefore, necessary to modify our study approach to compensate for such limitations by employing the following steps:

- Solicit comments from AFSC contracting offices and industry representative associations on profit policy problems and suggested improvements.
- Perform literature review of all pertinent articles, research studies, special reports, etc., which have been published since 1976.
- Duplicate analyses performed in Profit '76 to maximum extent practical.

- Perform additional analyses and tests which were more directly focused on specific profit policy problems.

Field Comments and Suggestions

In January 1982, we received comments from 12 AFSC contracting offices and 3 industry associations (Aerospace Industries Association, Electronic Industries Association, and National Security Industrial Association). There were a total of 75 improvements suggested, focusing on problems ranging from industry-wide issues to more limited concerns. The suggestions selected for further analysis within the scope of the AFSC Profit Study '82 were tested against two criteria: (1) must be profit policy related and (2) must involve an industry-wide problem. The resultant narrowed list of suggested improvements formed the general framework of analysis for the AFSC Profit Study '82.

Literature Review

Because of the limited financial data available for the AFSC Profit Study '82, it was necessary to augment our effort with other related research. This was particularly helpful in correlating our findings and conclusions with similar research. More than 30 items of literature on the subject of profit policy, published since 1976, were examined (see bibliography). Written abstracts were prepared on each; some of these are included in Appendix A.

Duplication of Profit '76 Analyses

The empirical evidence used to support the conclusions of the Profit '76 study was principally based on three tests:

- Comparison of five-year (1970-1974) profitability/return on investment statistics between the defense industry and commercial sector.

- Opinion survey of procurement personnel.

- Detailed analysis of profit statistics on defense contracts for 1975.

The profitability/return on investment statistics of government profit centers for 61 participating companies for the five-year period 1970-1974 were compared to similar statistics published by the FTC for durable goods producers. We performed a parallel analysis for the five-year period 1977-1981. Although we had no difficulty in obtaining FTC statistics or replicating the computations derived in the Profit '76 study, we did not have statistics on government profit centers. As an alternative, we examined the profit statistics of AFSC for the 1977-1981 period as maintained in DOD's DD Form 1499 (Report of Individual Contract Profit Plan) system. This review covered 1,760 contract actions with a total cost of more than $11 billion.

Profit '76 included a Procurement Personnel Opinion Survey which was participated in by 200 government employees. The objective of that survey was to examine attitudes on selected profit policy topics. We performed a similar survey for the AFSC Profit Study '82. Our questionnaire was divided into two parts. For Part I we included 16 questions verbatim from the Profit '76 survey to determine if there were any statistically significant changes in attitude since the profit policy revisions in DPC 76-3 and DAC 76-23. For Part II, we asked 24 questions that more specifically focused on today's problem areas. Although the survey was restricted to AFSC field activities, the characteristics of the respondents were remarkably similar to the Profit '76 survey. (Results of survey are included as Appendix B).

	Profit '76	AFSC '82
Number of Respondents	200	170
Average Years' Experience	15	17
Contracting Officer Participation	46%	54%

The third test performed in the Profit '76 study was a detailed examination of 535 DD Forms 1547 (Weighted Guidelines Profit/Fee Objective) submitted during 1975. The purpose of this test was to determine the profit objective tendencies of contracting officers across a spectrum of variables (e.g., contract type, cost mix, commodity, etc.). We matched this test with our review of DD Forms 1499 submitted on a total of 1,760 contract actions for the period 1977-1981.

Supplemental Analyses

Because there were areas not specifically addressed in the Profit '76 study, it was necessary to perform supplemental analyses for the AFSC Profit Study '82. For example, the special productivity factor did not exist at the time of the Profit '76 study. The database used to analyze these special areas was generally the same as previously discussed. Other information sources such as FINANDAS, CAS Board forms, etc., were used. Two of these tests deserve special mention.

First, we reviewed approximately 225 CAS Board Form-CMF (Facilities Capital Cost of Money Factors Computation) submitted by aerospace contractors for the period 1978-1982. Our review covered all defense contractors whose plant cognizance responsibilities had been assigned to AFSC's Air Force Contract Management Division. This included 15 corporations and 45 business units (14 of these corporations had been included in the Profit '76 database). The CMF forms were used to compute cost of money under CAS 414. They reflect the average annual net book value of tangible capital assets, as well as pools (e.g., engineering, manufacturing, etc.) to which these assets were assigned. Our purpose for examining these forms was to gain some insight on capital investment trends since Profit '76.

In a corollary analysis, we examined the 1981 corporate financial statements for 14 of these 15 aerospace contractors. We evaluated the profitability and investment trends among the commercial and defense related business segments of these corporations. These corporate financial statements provided segment-level statistics on operating revenue, operating profit, and capital expenditures for the 1979-1981 period.

Blue Ribbon Panel

A preliminary draft of the AFSC Profit Study '82 summary report was sent to a 12-member Blue Ribbon Panel for comment. The Blue Ribbon Panel was comprised of 6 representatives each from government and industry (see page iii). Panelists were asked independently to critque the study's findings and recommendations. We have modified the summary report to incorporate suggested improvements, where considered appropriate.

SUMMARY

The general thrust of our approach was to perform redundant evaluations of problem areas which would provide a cross-check for findings. In some areas, we did not have a comparable database to the one used in Profit '76 (e.g., profit center data). In other areas, however, we had a much larger database (e.g., DD Form 1499 management information system). The overall objective desired was to develop valid findings which would be supported by sufficient data and a credible analysis.

PART II

CURRENT PROFIT POLICY

The basis of today's profit policy was developed as a result of the Profit '76 study and the ensuing policy promulgated as DPC 76-3 in September 1976. This policy has remained essentially unaltered, except for a mid-course correction published as DAC 76-23 in February 1980. Before any viable analysis can be made on the results of these policy changes, it is important to establish a thorough baseline of the underlying rationale and objectives. This section summarizes the key elements of the Profit '76 study and the subsequent profit policy revisions.

PROFIT '76 STUDY

On 13 May 1975, the Deputy Secretary of Defense directed that a major study be performed on the relationship between contractor capital investment and corresponding productivity. There was a suspicion that the low levels of investment and productivity were attributable to low profit levels normally associated with the defense business. To prove or disprove this suspicion, an 18-person study team was formed. The study lasted approximately 16 months and was supported by other groups, such as the Joint Logistics Commanders, Defense Contract Audit Agency, Logistics Management Institute, General Accounting Office, industry representative associations, and a public accounting firm.

Although Profit '76 included several tests of trends, opinions, etc., the pivotal analysis was a comparative study of the differences in profitability between government and commercial business. The profit statistics of defense related profit centers were compared to profit statistics of durable goods producers published by the FTC. Comparisons were also made to commercial related profit centers, but this analysis proved inconclusive because it was not sufficiently typical for all commercial endeavors. The key findings of the Profit '76 study team were as follows:

1. The pre-tax return on sales ratio of realized profits was higher for the FTC durable goods producers than government profit centers. Specific statistics are shown in Exhibit 1.

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Exhibit 1
Return on Sales
1970-1974

	Realized Profit Before Taxes/Sales					
	1970	1971	1972	1973	1974	5-YEAR AVERAGE
FTC Durable Goods	5.7%	6.2%	6.9%	7.3%	7.0%	6.7%
Government Profit Centers	4.6	4.7	4.1	5.0	5.2	4.7

Source: Profit '76 Summary Report (8:II-15)

2. The pre-tax return on sales actually realized on government contracts was significantly less (approximately 46%) than the profit rate negotiated by contracting officers. The Profit '76 study team compared the average negotiated profit for all types of contracts, as reported by the DOD Comptroller, with the realized profit rates reported by government profit centers. See Exhibit 2.

Exhibit 2
Negotiated vs Realized Profit of Government Profit Centers
1970-1974

	Profit Before Taxes/Sales*					
	1970	1971	1972	1973	1974	5-YEAR AVERAGE
Negotiated	8.8%	8.8%	8.5%	8.7%	8.8%	8.8%
Negotiated Less Unallowables	6.8	6.9	6.6	6.5	6.8	6.8
Realized	4.6	4.7	4.1	5.0	5.2	4.7

*Normally, profit is expressed as a percentage of cost, not sales (or contract price). The Profit '76 study team converted the profit rates reported by the DOD Comptroller to a profit per sales base. As a percentage of cost, the five-year average of 8.8% would equate to 9.7%.

Source: Profit '76 Summary Report (8:II-21)

The data furnished by the government profit centers indicated that DAR Section 15 unallowables (e.g., interest, over-ceiling IR&D/B&P, etc) represented approximately 2% of sales. This theoretically reduced negotiated profit from 8.8% to 6.8%. The Profit '76 study team offered no explanation for the difference between 6.8% and the realized 4.7%, other than there was substantial profit erosion during contract performance. The most likely cause for this erosion was cost overruns. The Profit '76 study team observed that "if defense contractors could realize the negotiated profit rate less unallowables, the earnings of 6.8% would be very close to the average of 6.7%"

(8:II-20). The Profit '76 study team further concluded that the additional erosion was not a problem that could be solved through profit policy revisions. Instead, it was resolvable through more efficient cost control.

3. The pre-tax return on investment for government profit centers was higher than that achieved by FTC durable goods producers. See Exhibit 3.

Exhibit 3
Return on Investment
1970-1974

	Realized Profit Before Taxes/Total Assets*					
	1970	1971	1972	1973	1974	5-YEAR AVERAGE
Government Profit Centers	13.1%	12.6%	11.3%	15.5%	15.2%	13.5%
FTC Durable Goods	8.4	9.2	10.9	12.5	11.7	10.7

*Total assets were reduced by progress payments and advance payments

Source: Profit '76 Summary Report (8:II-26)

The above statistics demonstrated that, although government profit centers yielded a lower return on sales, they achieved a higher return on investment. There were two reasons attributed to this. First, government contract financing was far more favorable than provided in the commercial sector. Second, contractor capital investment for government related contracts was less than that invested in commercial business.

4. The next step in the Profit '76 study group's analytical process was to determine investment patterns. The initial task was to compare asset balances with sales levels. See Exhibit 4.

Exhibit 4
Assets/Sales
1970-1974

	Total Assets/Sales					
	1970	1971	1972	1973	1974	5-YEAR AVERAGE
FTC Durable Goods	68%	68%	64%	58%	60%	63%
Government Profit Centers	35	37	37	32	34	35

Source: Profit '76 Summary Report (8:II-30)

The Profit '76 study group found that the difference in investment was significant. However, this result was slightly distorted because of the more favorable contract financing policies of the government which greatly reduce the operating capital balances of government profit centers. To address this distortion, the group then further dissected this analysis but still found significant differences in the ratio of facilities capital to sales. The five-year averages for the FTC durable goods producers and government profit centers were 25.5% and 10.9%, respectively. This led the study group to surmise (8:II-35:36):

> There is a rough correlation between the amount of investment a company is willing to make and the amount of profit dollars that the company can expect to realize. . . If it is efficient in the commercial marketplace for the FTC durable goods producers to employ about 2 1/2 times the amount of facilities per dollar of sales, then there are probably productivity gains that could be made if defense contractors increased their investment. This increase in investment should decrease the production cost and price to the government.

The Profit '76 study group concluded that government contractors were able to maintain a high return on investment by keeping investment low. They recommended that the profit policy be revised to provide higher return on sales and, thus, stimulate capital investment. The desired result was to produce results similar to the FTC durable goods producers. This, in turn, should produce lower unit costs.

DPC 76-3

The recommended profit revisions of Profit '76 were promulgated in DPC 76-3 in September 1976 and were designed to increase investment and productivity. The most important revisions were as follows:

- The emphasis on CITP, a measure of contractor effort under the Weighted Guidelines, was reduced from 65% to 50% of profit.
- The emphasis on Contract Cost Risk was increased from 30% to 40% of profit. In general, the relative profit range on fixed-price type contracts was increased.
- A new factor, Contractor Investment in Facilities Capital, was added to the Weighted Guidelines and represented 10% of profit.
- The implicit recognition of cost of money on facilities capital was removed from profit and explicitly recognized as a contract cost under CAS 414.
- A Special Productivity Factor was added to the Weighted Guidelines to return the lost profit opportunity caused by productivity increases which lower the cost base.

- Because the relative weights of individual profit factors under the Weighted Guidelines format remained unchanged, a 30% degradation of CITP was created so that these profit policy revisions would not result in an overall increase in price to the government. This degradation was designed to offset the shift in emphasis, recognition of cost of money on facilities capital, etc. A popular misconception has been that the degradation was solely attributable to the recognition of cost of money on facilities capital.

In his statement to the Joint Committee on Defense Production on the purpose of these revisions, the Deputy Secretary of Defense stated (8:IX-29):

> We feel that our new profit policy and the allowance of the imputed cost of capital will help remove obstacles to cost-reducing facility investment decisions by industry. These policy changes are a step in the right direction and should reduce the DOD acquisition cost by improving the viability and productivity of our defense industrial base.

DAC 76-23

In February 1980, the profit policy was again revised, principally for the purpose of a mid-course correction. The underlying rationale for this change was based on an examination of practical experience with DPC 76-3. The examination revealed that there were four problems with Profit '76 (6:11):

> (1) The return on investment is not adequate to be a positive motivation for contractors to increase their facilities investment; (2) policy guidance for assigning weight to the contract cost risk factor is not sufficient; (3) there are too many exceptions to a manufacturing oriented profit policy; (4) the relationship between R&D and service profit levels is not desirable.

As a result, three policy revisions were undertaken.

First, various studies indicated that the 6-10% weight for contractor investment in facilities was not an influencing factor in contractor investment decisions. At the time of DPC 76-3, the weight for this factor had been acknowledged to be a modest amount; therefore, an increase had been imminent. The weights were increased to 16-20% which would correspondingly increase this factor's percentage of total profit objective from 10% to 17%. It should be noted that no change was made to the 30% offset factor to compensate for this shift in emphasis.

Second, DOD concluded that there were many situations where it was not desirable to apply an investment-oriented profit policy. For example, in cases where facilities capital was not used in performance of a contract,

Exhibit 5

Summary of Profit Policy Changes

Weighted Guidelines Profit/Fee Objective	Before Profit '76	DPC 76-3	DAC 76-23		
	All Contracts	All Contracts	Manufacturing	R&D	Services
Contractor Effort:					
Direct Materials:					
Purchased Parts	1 to 4%	1 to 4%	1 to 4%	1 to 4%	1 to 4%
Subcontracts	1 to 5%	1 to 5%	1 to 5%	1 to 5%	1 to 5%
Other Materials	1 to 4%	1 to 4%	1 to 4%	1 to 4%	1 to 4%
Engineering Labor	9 to 15%	9 to 15%	9 to 15%	9 to 15%	N/A
Engineering Overhead	6 to 9%	6 to 9%	6 to 9%	6 to 9%	N/A
Manufacturing Labor	5 to 9%	5 to 9%	5 to 9%	5 to 9%	N/A
Manufacturing Overhead	4 to 7%	4 to 7%	4 to 7%	4 to 7%	N/A
Services Labor	N/A	N/A	N/A	N/A	5 to 15%
Services Overhead	N/A	N/A	N/A	N/A	4 to 8%
G&A Expense	6 to 8%	6 to 8%	6 to 8%	6 to 8%	6 to 8%
Adjustment Factor Deduction	N/A	(30% of effort)	(30% of effort)	N/A	N/A
Contractor Risk	0 to 7%	0 to 8%	0 to 8%	0 to 7%	0 to 4%
Facilities Investment		6 to 10%	16 to 20%	N/A	N/A
Record of Performance	-2 to 2%				
Selected Factors	-2 to 2%				
Special Factors:					
Foreign Military Sales	1 to 4%	1 to 4%			
Independent Development	1 to 4%	1 to 4%	1 to 4%	1 to 4%	N/A
Productivity		*	*	N/A	N/A
Other		-5 to 5%	-5 to 5%	-5 to 5% (Total)	-5 to 5% (Total)
Cost of Money Adjustment					

*The Special Productivity Factor was to be the cost decrease multiplied by the base profit rate

there would be little advantage to encourage increased capital investment. To correct this situation, the Weighted Guidelines were significantly modified. Separate profit weight ranges were created for manufacturing, research and development, and service contracts.

Third, the risk factors among contract types were significantly changed. The separate factors for cost and multiple incentives had been combined under DPC 76-3. They were reinstated under DAC 76-23, as well as providing separate factors for manufacturing, R&D, and service contracts. These changes are discussed in more detail in Part III.

Summary

The principal objective of Profit '76, DPC 76-3, and DAC 76-23 was to achieve cost reductions through increased capital investment. The profit policy was modified so that profit could serve as a tangible stimulus for capital investment. Exhibit 5 details the specific revisions to the Weighted Guidelines.

PART III

PROFITABILITY 1977 - 1981

The Profit '76 study team examined the topic of profitability from several perspectives, principally as a return on sales and return on investment (total assets less progress payments and advance payments). In a comparison between government profit centers and FTC durable goods producers, they found significant differences among these profitability indicators. This moved them to adopt a DOD profit policy which would increase return on sales and, therefore, stimulate capital investment (8:II-36). In this section, we will examine whether the desired shifts in profit trends have occurred. We will also examine the issue of profitability and its relationship to the Weighted Guidelines method of establishing profit objectives on defense contracts.

PROFIT COMPARABILITY

The Profit '76 study team compared the realized profits (before taxes) of FTC durable goods producers with the performance of government profit centers. As previously noted in Exhibit 1, the five-year average for the 1970-1974 period was 6.7% for FTC durable goods producers as compared to 4.7% for the government profit centers. The corresponding return on investment for this five-year period was 10.7% for FTC durable goods producers and 13.5% for government profit centers (see Exhibit 3). We calculated the profitability and return on investment performance of the FTC durable goods producers in the same manner for the five-year period 1977-1981 and, as shown in Exhibit 6, noted the following:

Exhibit 6
Realized Profit Performance FTC Durable Goods Producers
1977-1981

	1977	1978	1979	1980	1981	5-YEAR AVERAGE
Profit Before Taxes/Sales	7.8%	8.1%	7.2%	5.4%	6.8%	6.9%
Profit Before Taxes/Total Assets*	13.4	14.4	12.7	8.9	10.4	11.6

*Less Progress Payments and Advance Payments

Source: Federal Trade Commission's Quarterly Financial Report

The above profit statistics indicated that for the FTC durable goods producers the realized pre-tax profit on sales for the 1977-1981 period had only slightly increased over the earlier five-year period (6.7% versus 6.9%). However, the return on investment increased from 10.7% to 11.6%. We found that the minimal change in the realized pre-tax profit/sales ratio but corresponding increase in the realized pre-tax profit/total assets ratio resulted from a

reduction in the relationship between total assets and sales. For the 1970-1974 period, the total assets/sales ratio had been 63% for the FTC durable goods producers. This ratio decreased to 60% for the 1977-1981 period. Because the facilities capital/sales ratio (26%) remained unchanged between these two periods, we concluded that the overall decrease in the total assets/sales ratio was due to a decrease in the relative proportion of net working capital. This will be discussed in greater detail later in the report.

We then turned to the profit performance of defense contracts. Although we did not have statistics on government profit centers as did the Profit '76 study team, there were alternatives available which would document profitability trends. We compared the negotiated profit rates on government contracts as reported by the DOD Comptroller in Exhibit 2 for the five-year period 1970-1974 with similar statistics for the five-year period 1977-1981 (see Exhibit 7). These statistics were maintained in the DOD DD Form 1499 management information system and are summarized below. Some members of the Blue Ribbon Panel criticized our reliance on the DD Form 1499 profit data. We agree individual reports represent the contracting officer's perception of negotiated profit; however, we used the entire universe of DD Form 1499 data over a five-year period. We believe these data, in the aggregate, represent valid profit trends. Furthermore, since this database has been used previously by DOD to formulate profit policy, we believe our use of the DD Form 1499 data is both valid and consistent.

Exhibit 7
Negotiated Profit on AFSC Contracts*
(Includes Cost of Money on Facilities Capital)
1977-1981

	Profit Before Taxes/Sales**						
Type Contract	1970-1974	1977	1978	1979	1980	1981	5-YEAR AVERAGE
FFP	10.0%	11.5%	11.5%	11.3%	12.7%	11.6%	12.0%
FPI	9.1	10.2	10.6	10.6	10.8	10.7	10.6
CPIF	7.7	7.8	8.3	9.1	8.8	8.7	8.7
CPFF	7.4	7.7	7.2	7.6	7.9	8.5	7.7
Weighted Average	8.8%	9.6%	10.1%	10.4%	11.3%	10.3%	10.6%
As Percentage of Cost	9.7%	10.6%	11.2%	11.6%	12.8%	11.6%	11.8%

*These profit statistics represented amounts considered as being negotiated by contracting officers. Realized profits would depend upon actual contract performance.

**Profit Before Taxes/Sales was derived by converting profit statistics (based on cost) in same manner as Profit '76 study team.

Source: DOD DD Form 1499 database

Consistent with the stated objectives of DPC 76-3, there has been an increase in return on sales for defense contracts (from 8.8% to 10.6%). Assuming that DAR Section 15 unallowables would still approximate 2% of sales (see Exhibit 2), the net profit on sales would equate to 8.6% (10.6% - 2%). We were confident that the profit on sales performance of defense contracts was reasonably similar to the performance of the FTC durable goods producers. Our conclusion correlated highly with a study of profitability on defense contracts conducted by the University of Notre Dame in 1980. They observed that "there has been no consistent and significant difference found in profitability of civilian as compared to defense contracting firms" (4:i). The Aerospace Industries Association, using data developed by the FTC, summarized the profit performance of 1981, "The aerospace profit (after taxes) edged closer to, but remained below, the average for all U.S. manufacturing corporations, which was 4.7%" (2:142). The Aerospace Industries Association had reported profits (after taxes) of 4.3% for 1981. Although these were after-tax profit statistics, they did support our conclusion that comparability has been reasonably achieved.

We also performed an analysis of the published 1981 corporate financial statements of 15 top aerospace contractors (14 of these corporations were included in the Profit '76 database). We compared the realized operating profit (before interest and taxes) of the total corporation with the performance of those business segments substantially engaged in defense contracts. The results, shown in Exhibit 8, also confirmed that there was little difference in the profitability of commercial versus defense business.

Exhibit 8
Comparative Analysis of Operating Profit
15 Selected Top Aerospace Contractors
1979 and 1981
($ Million)

	Total Corporation	Defense Related Segments
1979:		
Sales	$ 77,016	$27,011
Operating Profit*	5,996	2,091
Operating Profit/Sales	9.1%	7.7%
1981:		
Sales	$100,517	$40,228
Operating Profit	8,018	3,254
Operating Profit/Sales	8.0%	8.1%

*Although interest expense was excluded from operating profit, we have no reason to believe it would be proportionately higher for the defense related segments. In fact, because government contract financing was likely to be more favorable than provided in the commercial sector, interest expenses may have been proportionately less for the defense related segments.

Source: 1981 Corporate Financial Statements

Some Blue Ribbon Panel members also cautioned us on use of corporate financial statements, noting that individual segments may be engaged in widely different product lines. This ostensibly would distort comparisons. We do not agree that a significant distortion would exist when comparing aggregate amounts. This test was designed to provide a cross-reference to similar analyses conducted for the same purpose. Because the results of these analyses highly correlate, we were confident with our overall conclusions on profit trends.

DISTRIBUTION OF PROFIT FACTORS

We next compared the actual distribution of profit factors for the 1977-1981 period with those desired in DPC 76-3 and DAC 76-23. These objectives, shown earlier in detail in Exhibit 5, are summarized below in Exhibit 9. It should be noted that when the capital employed profit factors were increased in DAC 76-23 to represent 17% of profit, there were no changes to either the other profit factors or the CITP offset factor. We presumed that, since the combination of CITP and risk would decrease from 90% to 83% of total profit (i.e., 100%-17%), the reductions would be proportionate.

Exhibit 9
Desired Redistribution of Profit Factors
As Percentage of Total Profit Objective

	Before Profit '76	DPC 76-3	DAC 76-23
CITP	65%	50%	46%
Risk	30	40	37
Capital Employed	N/A	10	17
Other	5	+ or -	+ or -
Total	100%	100%	100%

Using DOD's DD Form 1499 management information system, we determined the actual distribution patterns for the five-year period 1977-1981. These statistics, shown as Exhibit 10, were the profit objectives on AFSC contracts.

Exhibit 10
Distribution of Profit Factors on AFSC Contracts
As Percentage of Total Profit Objective
1977-1981

Profit Factors*	1977	1978	1979	1980	1981
CITP	49%	46%	45%	42%	52%
Risk	43	46	48	51	39
Capital Employed	8	8	7	7	9
Total	100%	100%	100%	100%	100%

*For purposes of comparison, these percentages were based on total profit less special profit factors. Inclusion of special profit factors would not change these results because these factors normally represented only 2-3% of total profit.

Source: DOD DD Form 1499 database

It was clear from the above statistics that the desired redistribution of profit factors was not fully achieved. Although the impact of CITP has been reduced from the 65% experienced prior to Profit '76, the reduction for the period 1978-1980 was far greater than that desired in DPC 76-3. However, the impact of CITP significantly increased after DAC 76-23. Conversely, the importance of risk actually experienced during 1978-1980 was far more than the 40% goal, but this factor was greatly reduced after DAC 76-23. The capital employed factor was reasonably close to the 10% goal of DPC 76-3 but significantly less than the 17% goal of DAC 76-23. This raised serious doubt on the ability of DPC 76-23 to increase profit inducements for capital investment. The distribution by individual contract type is shown in Exhibit 11.

Exhibit 11
Distribution of Profit Factors*
As Percentage of Total Profit Objective
By Contract Type
1977-1981

	1977	1978	1979	1980	1981
FFP:					
CITP	33%	33%	35%	34%	38%
Risk	62	60	60	60	52
Capital Employed	5	7	5	6	10
Total	100%	100%	100%	100%	100%
FPI:					
CITP	44%	42%	44%	46%	56%
Risk	46	50	49	46	37
Capital Employed	10	8	7	8	7
Total	100%	100%	100%	100%	100%
CPIF:					
CITP	62%	65%	65%	62%	66%
Risk	30	25	25	27	24
Capital Employed	8	10	10	11	10
Total	100%	100%	100%	100%	100%
CPFF:					
CITP	78%	81%	79%	87%	91%
Risk	9	9	10	6	5
Capital Employed	13	10	11	7	4
Total	100%	100%	100%	100%	100%

*For comparison purposes, these percentages were based on total profit less special profit factors. Inclusion of special profit factors would not change these results because these factors normally represented only 2-3% of total profit.

Source: DOD DD Form 1499 database

ANALYSIS OF PROFIT RATES INCREASES

In order to determine the specific causes for the increase in negotiated profit objectives between the 1970-1974 and the 1977-1981 periods, it was necessary to create a baseline for comparison. This was accomplished by superimposing DPC 76-3 policy changes on the actual profit experience existing at the time of Profit '76, as shown below in Exhibit 12. All relevant variables were taken into account, such as cost mix, contract type, Treasury Rate, etc. The net result of this approach would produce the profit factors necessary to achieve the desired redistribution of DPC 76-3 and the profit objective of 9.7% achieved in 1975 for DOD, including cost of money.

Exhibit 12
Profit Objective on DOD Contracts
Actual Profit Factors
1975

	FFP	FPI	CPIF	CPFF	WEIGHTED AVERAGE	DISTRIBUTION
CITP	5.5%	6.3%	7.2%	8.0%	6.5%	67%
Risk	5.8	3.2	1.3	.1	3.0	31
Past Performance	.5	1.0	0	0	.2	2
Total	11.8%	10.5%	8.5%	8.1%	9.7%*	100%
Distribution (Cost)	27%	25%	28%	20%		

*Equates to 8.8% based on sales

Source: DOD Comptroller Report - Profit Rates on Negotiated Prime Contracts

We took into account the three basic changes of DPC 76-3. First, cost of money on facilities capital was recognized as an element of cost rather than profit. Second, an adjustment factor was created to offset the cost of money and to reduce the importance of CITP from 65% to 50%. Third, the weight ranges for risk on most contract types were increased one percentage point. The projected impact of these policy revisions on the 9.7% profit objective which existed at the time of Profit '76 is shown in Exhibit 13. For example, CITP was 6.5% in 1975 and represented approximately 65% of the total profit objective of 9.7%. The CITP figure was adjusted to 4.4% in order to represent 50% of the 1975 profit objective, excluding cost of money.

Exhibit 13
Comparative Baseline
DPC 76-3 Profit Policy Revisions

	Average Profit Factors Applied for 1975					
CITP	FFP 3.6%	FPI 4.2%	CPIF 4.7%	CPFF 5.2%	WEIGHTED AVERAGE 4.4%	DISTRIBUTION 50%
Risk	6.8	4.2	2.3	.5	3.6	40
Capital Employed	.5	1.1	.7	.8	.8	10
Subtotal	10.9%	9.5%	7.7%	6.5%	8.8%	100%
Cost of Money	.5	1.1	.7	.8	.9	
Total	11.4%	10.6%	8.4%	7.3%	9.7%*	

*Equates to 8.8% based on sales.

The differences between actual profit experience and the Profit '76 baseline were traceable to a number of items: contract cost mix, contract type mix, applied Weighted Guidelines factors, capital employed, Treasury Rate, and special profit factors. The amount attributable to any one item was developed using standard variance analysis techniques. For example, use of FFP contracts increased from 27% in 1975 to 31% in 1978. If everything else had remained constant, this volume increase in FFP contracts alone would increase the overall profit objective in 1978.

We compared the actual profit experience for the period 1977-1981 with the baseline created from the profit policy revisions. These results are shown in Exhibit 14.

Exhibit 14
Profit Objective on AFSC Contracts
Analysis of Differences From Baseline
1977-1981

	Profit as Percentage of Cost				
	1977	1978	1979	1980	1981
CITP*	4.6%	4.4%	4.8%	4.7%	5.2%
Risk	4.0	4.5	5.0	5.6	4.2
Capital Employed	.8	.8	.8	.7	1.0
Cost of Money	.8	.9	.9	.9	1.3
Special Factors	.3	.1	.2	.3	.1
Profit Objective	10.5%	10.7%	11.7%	12.2%	11.8%
Baseline Objective	(9.7)	(9.7)	(9.7)	(9.7)	(9.7)
Net Difference	.8%	1.0%	2.0%	2.5%	2.1%
Changes Due To:					
Mix Contract Type		.3	.7	1.1	.6
Mix Contract Cost	.2	.2	.5	.3	.6
Applied Factors	.3	.3	.6	.9	.4
Capital Employed		.1	(.2)	(.2)	
Treasury Rate			.2	.1	.4
Special Factors	.3	.1	.2	.3	.1
Net Difference	.8%	1.0%	2.0%	2.5%	2.1%

*CITP is shown net of offset

Our analysis disclosed that there were several reasons for the profit rate increases from the 1975 baseline.

- AFSC had a higher mix of FFP and FPI contracts during 1977-1981 than the DOD average in 1975 (approximately 65% versus 50% based on cost). This accounted for about 32% of the profit rate increases for this period.

- Another 21% was due to relative change in cost mix among contract types. For example, material on FFP contracts in 1977 represented 48% of total costs. In 1981, material represented only 28%. Since material is the lowest among CITP profit factors (1-4% range), any decrease in the relative proportion of material or subcontracts would cause an increase in profit.

- Approximately 30% was attributable to higher factors being applied by contracting officers, mostly for contract risk. For example, risk on FFP contracts rose from 6.9% in 1977 to 7.5% in 1980.

- Another 8% was attributable to increases in the Treasury Rate used to compute cost of money which rose from about 8% in 1977 to approximately 15% in 1981.

- The application of special factors represented 11% of the increase.

Exhibit 15
Profit Objective on AFSC Contracts
Actual Profit Factors
By Contract Type
1977-1981

	COMPARATIVE BASELINE TO DPC 76-3	1977	1978	1979	1980	1981
FFP:						
CITP*	3.6%	3.8%	3.9%	4.2%	4.3%	4.6%
Risk	6.8	6.9	6.9	7.1	7.5	6.8
Capital Employed	.5	.5	.8	.7	.8	1.5
Special Factors		.6	.2	.1	.3	.1
Cost of Money	.5	.5	.9	.7	.8	1.3
Total	11.4%	12.3%	12.7%	12.8%	13.7%	14.3%
FPI:						
CITP*	4.2%	4.4%	4.2%	4.9%	4.8%	5.8%
Risk	4.2	4.7	5.1	5.3	4.9	3.9
Capital Employed	1.1	.9	.9	.8	.9	.8
Special Factors		.4	.1	.3	.1	.3
Cost of Money	1.1	.9	.9	.8	1.0	1.2
Total	10.6%	11.3%	11.2%	12.1%	11.7%	12.0%
CPIF:						
CITP*	4.7%	4.9%	5.1%	5.5%	5.1%	5.1%
Risk	2.3	2.4	1.9	2.1	2.2	1.8
Capital Employed	.7	.7	.8	.9	.9	.8
Special Factors				.3	.2	.1
Cost of Money	.7	.7	.8	1.1	1.1	1.1
Total	8.4%	8.7%	8.6%	9.9%	9.5%	8.7%
CPFF:						
CITP*	5.2%	5.4%	5.2%	5.5%	6.1%	6.1%
Risk	.5	.6	.6	.7	.4	.4
Capital Employed	.8	.9	.7	.8	.5	.3
Special Factors		.2	.1	.1	.1	.2
Cost of Money	.8	1.0	.8	1.0	1.1	1.8
Total	7.3%	8.1%	7.4%	8.1%	8.2%	8.8%

*CITP is shown net of offset

Source: DOD DD Form 1499 database

22-859 O - 83 - 10

It is particulary important to note that increases in capital employed did not increase overall profits. In fact, the changes of DPC 76-23 which did not recognize capital employed on R&D and service contracts has caused a reduction in the total amount of capital employed recognized on defense contracts.

It was very clear from this analysis that profit rate increases were not attributable to Profit '76. The increases were caused by factors that reflected changes in the business environment, such as contract type mix, cost mix, or applied factors. A significant finding of the AFSC Profit Study '82 was that increased profits would have occurred without the policy changes emanating from Profit '76. Specific factors for each contract type are detailed in Exhibit 15.

CITP

The current profit policy awards profit on three basic elements: CITP, risk, and capital employed. According to DAR 3-808.5, the first of these factors (CITP) is a measure of how much effort is exerted by the contractor to meet contract performance requirements in an efficient manner. This factor is apart from the contractor's responsibility for contract performance. It takes into account what resources are necessary to produce the deliverable end item. The various profit weights for CITP were initially developed in 1964 and have remained unchanged since then. In a supporting analysis by the Logistics Management Institute, the Profit '76 study team performed a detailed review of profit statistics for 1975 in order to gain better insight of the profit tendencies of contracting officers for CITP. They examined 535 DD Forms 1547 which documented the Weighted Guidelines factors used to establish profit objectives. They found that the CITP factors were distributed as shown in Exhibit 16 (8:V-18):

Exhibit 16
Distribution of Mean Profit Objectives
Weighted by Cost Category and Contract Type
As Percentage of Measurement Base
1975

CITP Cost Category	Weight Range	CPFF	CPIF	FPI	FFP	ALL CONTRACTS
Purchased Parts	1-4%	2.4%	3.0%	3.2%	3.1%	3.1%
Subcontracts	1-5	4.2	3.5	4.1	3.7	3.5
Other Materials	1-4	3.2	2.7	2.7	3.1	2.9
Engineering Labor	9-15	12.6	11.7	12.3	12.3	12.1
Engineering Overhead	6-9	7.6	7.4	7.6	7.6	7.5
Manufacturing Labor	5-9	6.9	7.5	7.8	7.5	7.5
Manufacturing Overhead	4-7	5.7	5.6	6.1	5.8	5.9
Other Costs	N/A	3.8	5.6	6.4	6.0	5.6
G&A	6-8	7.2	7.0	7.2	7.1	7.1
Total		7.0%	6.4%	5.7%	5.3%	5.9%*

*DOD Comptroller reported a 6.5 average for all contracts

Source: Profit '76 Summary Report (8:V-18)

The Profit '76 study team concluded that the overall differences among contract types were traceable to the nature of work performed under each contract. Fixed-price type contracts were mostly associated with production effort and principally characterized by a heavy proportion of material and subcontract costs (48%) which have low CITP profit weights. In contrast, cost type contracts were normally used for research and development that were principally characterized by engineering labor and overhead (40%) which have much higher CITP profit weights.

Their analysis, however, disclosed a major disparity in the weighting tendencies of contracting officers. The weightings given to purchased parts, subcontracts, and materials were normally much higher than the mid-point of the weight range. The weightings given to a contractor's value added effort (labor, overhead, G&A) were normally equal to or less than the mid-point of the range. They summarized their findings on this disparity as follows (8:V-20):

> The . . . profit weight ranges inherently provide higher profits on contracts which utilize higher amounts of contractor capital investment. This results from assignment of lower profit weight ranges to the costs of direct materials, which normally require relatively low investment, and higher profit weight ranges to the value-added cost elements (such as engineering), which normally require higher levels of investment. However, in establishing pre-negotiation objectives, the DOD negotiators put significantly more profit weight on direct material costs, and less on the value-added costs.

We duplicated this analysis for the five-year period 1977-1981 by using the DOD DD Form 1499 management information system. Our analysis which included 1,760 contract actions with a total value of approximately $11 billion is summarized in Exhibit 17.

Exhibit 17
Distribution of Mean Profit Objectives
Weighted by Cost Category and Contract Type
As Percentage of Measurement Base
1977-1981

CITP Cost Category	Range	CPFF	CPIF	FPI	FFP	ALL CONTRACTS
Material*	1-4%	3.7%	3.8%	3.8%	3.9%	3.8%
Engineering Labor	9-15	12.6	12.2	12.3	12.4	12.3
Engineering Overhead	6-9	7.8	7.4	7.5	7.7	7.6
Manufacturing Labor	5-9	7.7	7.5	7.5	7.8	7.7
Manufacturing Overhead	4-7	5.9	5.6	6.0	5.9	5.9
Services Labor**	5-15	11.4	5.6	11.3	10.7	10.3
Services Overhead**	4-8	5.1	6.8	6.7	6.8	6.6
Other Costs	N/A	5.0	4.8	6.7	6.1	5.9
G&A	6-8	7.1	7.2	7.1	7.1	7.1
Profit Subtotal		7.8	7.3	6.5	6.0	6.6
Offset	(30%)	(2.2)	(2.1)	(1.8)	(1.8)	(1.9)
Total		5.6%	5.2%	4.7%	4.2%	4.7%

*Includes subcontracts which has a range of 1-5%

**Added as part of DAC 76-23

Source: DOD DD Form 1499 database

A comparison of the 1977-1981 period with the individual profit factors assigned in 1975 disclosed a large increase in the factors for material (3.1% to 3.8%) and only slight increases in the other factors. For material, the profit factors were close to the maximum, producing a far greater disparity than that observed by the Profit '76 study team. We also noted what appeared to be a migration of costs from the material category to the "other" category. In 1977, these categories represented 39% and 7% of total costs, respectively. While the relative distribution of all other factors remained somewhat unchanged in 1981, material decreased to 29% and "other" increased to 20%. It should be noted that the average profit factor for "other" was about 50% greater than the profit factor assigned to material (5.9% versus 3.8%).

In our opinion, the trends in material were a strong statement by contracting officers that the profit ranges on material were no longer relevant to today's business environment. There are two arguments which would support this contention. First, if CITP is to be a proper measure of resource application, then the profit policy should recognize that material is typically the largest component of contractor investment in the work-in-process inventory. Thus, the inventory carrying costs for material are normally higher than for other cost categories. Second, the complexities associated with material and subcontract management have likely increased since 1964, when the profit ranges for these factors were created. We believe the profit range for material is too low. This is particularly evident when compared to the profit range for G&A (6-8%) which, as a period cost, has far less relationship to contractor effort than the other factors which are product costs.

RISK

The realized before tax profits of government profit centers for the five-year period 1970-1974 had been 4.7% for fixed-price type contracts and 4.4% for cost type contracts (8:II-19). The Deputy Secretary of Defense concluded that revisions were needed to correct this (8:IX-7):

> The cost type contract five-year average was 4.4%, which is .3% lower than the fixed-price average. This relationship appears disproportionate since a contractor with a fixed price contracts assumes a significantly greater risk and should be able to earn more profit than a contractor with a cost type contract.

In order to acheive a greater discrimination between fixed-price type and cost type contracts, DPC 76-3 increased the differences in risk factors. These are shown next page in Exhibit 18.

Exhibit 18
DPC 76-3 Changes in Risk Factors
As a Percentage of Contract Cost

	Profit Policy		Actual	
	Before Profit '76	DPC 76-3	1975	1977-1980
FFP	5-7%	6-8%	5.8%	7.1%
FPI -		3-6	3.2	5.0
Cost Incentive	2-4			
Multiple Incentives	3-5			
CPIF -		1-3	1.3	2.2
Cost Incentive	1-2			
Multiple Incentives	1.5-3			
CPFF	0-1	0-1	0	.6

Sources: 1975 - DOD Comptroller Report - Profit Rates on Negotiated Prime Contracts
1977-1981 - DOD DD Form 1499 database

We noted that DPC 76-3 increased the profit range for FFP contracts by one percentage point. The range for FPI contracts with cost incentives actually increased two percentage points due to the elimination of separate ranges for cost versus multiple incentive arrangements (i.e., maximum increased from 4% to 6%). The range for CPFF contracts remained the same, but the elimination

of separate ranges for cost versus multiple incentive CPIF contracts allowed a one percentage point increase for CPIF contracts with cost incentive arrangements.

We found that the policy changes of DPC 76-3 did little to increase the relative difference between fixed-price type and cost type contracts. This was confirmed by our analysis of the period 1977-1980 (1981 excluded because of DAC 76-23), where risk factors on FFP/FPI contracts averaged 6.1% and CPIF/CPFF contracts averaged 1.4%. This produced a relative difference of 4.7% (6.1%-1.4%) in the actual profit factors for risk as compared to 3.7% for the 1970-1974 period.

Given these differences in profit factors for risk, there has actually been little increase in the overall profit difference between these contract types. The overall difference in profit between FFP/FPI and CPIF/CPFF contracts was 2.7% for the 1970-1974 period and 3.6% for the 1977-1980 period. If a 2.7% difference produced little differentiation in realized profits for the 1970-1974 period, then it is doubtful that there was much additional distinction in realized profits for the subsequent period.

The policy revisions of DAC 76-23 significantly changed the profit factors attributable to risk. The changes are shown in Exhibit 19.

Exhibit 19
DAC 76-23 Changes in Risk Factors
As a Percentage of Contract Cost

	MFG	R&D	SER
FFP	6-8%	5-7%	3-4%
FPI -			2-3
Cost Incentive	3-5	2-4	
Multiple Incentives	4-6	3-5	
CPIF -			1-2
Cost Incentive	1-2	1-2	
Multiple Incentives	1.5-3	1.5-3	
CPFF	0-.5	0-.5	0-.5

Generally, DAC 76-23 restored the risk factors for R&D and service contracts to the policy which existed prior to Profit '76. This would have the effect of reducing profit attributable to risk by roughly 1 to 2 percentage points for R&D contracts and up to 3 percentage points for service contracts. For example, maximum profit on an FPI contract for services could have been 6% under DPC 76-3 but now only 3% under DAC 76-23. The risk factors for manufacturing contracts remained mostly unchanged except for CPFF contracts and CPIF contracts with cost incentives.

Interestingly, the policy changes for risk under DAC 76-23 still did not produce much difference in the actual profit factors achieved in 1981, the first full year of the DAC 76-23 policy. The difference between risk factors on FFP/FPI and CPIF/CPFF contracts for 1981 was 4.3% which was a drop from the 4.7% achieved for the 1977-1980 period. This was mostly caused by the use of separate factors for R&D and service contracts. The overall difference in profit between these contract types in 1981 increased from 3.6% to 4.4%. This was not, however, caused by policy changes in risk factors. Instead, it was due to other changes affecting R&D and service contracts, such as the elimination of capital employed profit and the dollar-for-dollar offset for cost of money.

CAPITAL EMPLOYED

Our analysis of the capital employed profit factor under the Weighted Guidelines is discussed in Part IV of this summary report.

SUMMARY

The profit performance among the FTC durable goods producers, as measured by return on sales, had remained relatively unchanged since Profit '76. During this same period, however, the return on sales which were negotiated on defense contracts had increased from 8.8% to 10.6% (about 20% increase). Our analysis revealed that such increases on defense contracts were not attributable to DPC 76-3. These increases were almost totally due to changes in contract type mix, contract cost mix, and higher factors being applied by contracting officers. We observed that these increases in defense profits would have occurred even if there had been no change in DOD profit policy.

The Profit '76 study team had concluded that DOD should construct a policy which would provide profit comparability between defense contracts and the commercial sector. Our examination of a number of key indicators disclosed that such comparability was most likely achieved for the 1977-1981 period. Notwithstanding the specific causes for profit increases, we were confident that the gap in realized profit between defense contracts and FTC durable goods producers has significantly decreased.

The desired relative distribution among profit factors (i.e., CITP, risk, capital employed) was not achieved. This was principally caused by the dynamics within the contracting environment such as contract type, cost mix, etc., which have perceptively changed since 1976. For example, the increases in fixed-price type contracts would shift distribution of profit from CITP to risk. The capital employed factor was approximately the 10% desired under DPC 76-3, but was significantly less than the 17% desired under DAC 76-23.

The CITP profit factors on individual cost elements have remained unchanged since the inception of the Weighted Guidelines method in 1964. There was strong evidence which suggests that they are no longer relevant to today's contracting environment. For example, the 1-4% factor for material is probably too low, and the 6-8% factor for G&A is too high.

The Profit '76 study team developed a policy which was designed to provide greater distinction in realized profits between fixed-price and cost type contracts. The profit factors for risk were changed under DPC 76-3 and again under DAC 76-23. Our review disclosed, however, that not much increase in profit distinction was actually achieved as a result of these specific changes. If any distinction was achieved from DAC 76-23, it was a result of now treating R&D and service contracts with profit guidelines similar to that which existed prior to Profit '76. It is very important to note, however, that the 5% profit factor for past performance was not reinstated on such contracts. It was also apparent that the many changes in DOD's profit policy toward risk have caused much confusion for field contracting offices.

Specific actions in regard to these findings are presented in Part VII of this report.

PART IV

PROFIT AND CAPITAL INVESTMENT

The goal of the profit policy revisions in DPC 76-3 and DAC 76-23 was to increase capital investment . Simply put, the Profit '76 study team reasoned that increased profit expectations will cause more capital investment which, in turn, will cause increased productivity. There is strong sentiment today, however, that this objective has not been achieved. This was particularly evident in our Acquisition Personnel Opinion Survey, as shown below:

	Agree	Disagree	No Opinion
The profit policy revisions in DPC 76-3 have resulted in increased investment.	15%	51%	34%
The profit policy revisions in DAC 76-23 have resulted in increased investment.	18%	47%	35%

These results showed that few agree that these policies have worked, in spite of the fact that an overwhelming 68% agreed that profit can be an effective tool for encouraging investment (versus 18% who did not). In addition, 59% still believed that increased capital investment will produce cost reductions (15% did not). Thus, while there has been confidence in the basic role of profit in incentivizing capital investment, its impact under the current structure has been doubtful. These views were similar to views expressed in the literature. A few of these are presented below.

Item 1: Final report of Advanced Management Systems, Inc. (1978) - "One of the major findings emanating from this study is that DPC 76-3 has had only minimal impact on the investment plans, policies, and actions of those major AFSC contractors AMS interviewed." (1:43)

Item 2: General Accounting Office (1979) - ". . . the increased profits and other policy incentives have not been sufficient to motivate many defense contractors to invest in additional cost-reducing facilities. As a result, DOD has not accomplished its objective to reduce production costs through additional contractor investments in more efficient facilities." (5:18)

Item 3: Research study performed for National Defense University (1980) - "There is little evidence that the profit policy changes promulgated since Profit '76 have had notable practical effect." (7:45)

Exhibit 20
Net Book Value of Tangible Capital Assets
Selected Aerospace Contractors
1978-1982

Contractor	Net Book Value ($ Million) 1978	1979	1980	1981	FORECAST 1982
A	$ 18.9	$ 25.6	$ 30.0	$ 44.4	$ 41.6
B	10.3	14.4	19.5	24.8	40.9
C	14.5	23.7	34.3	46.7	54.7
D	41.5	44.5	55.3	83.5	106.7
E	86.2	78.6	75.0	78.4	183.8
F	76.8	131.4	172.0	227.8	399.4
G	51.9	57.7	68.5	85.9	109.4
H	18.7	19.4	22.5	31.1	36.6
I	116.4	154.9	241.1	349.3	398.4
J	107.1	110.4	138.8	201.9	307.2
K	81.1	87.7	103.1	133.6	182.2
L	30.0	36.3	45.9	67.2	101.6
M	177.4	200.3	248.7	335.5	437.1
N	210.4	289.9	343.2	463.1	771.8
O	323.6	426.5	668.2	908.9	996.3
Total	$1,364.8	$1,701.2	$2,266.1	$2,948.6	$4,138.9

Source: CAS Board Form - CMF

Item 4: Report of Defense Industrial Base Panel (1980) - "The panel finds that current tax and profit policies appear to discourage capital investment in new facilities and equipment that would increase productivity and improve the condition of the defense industrial base." (9:42)

Item 5: Naval Postgraduate School thesis (1980) - "DOD PCO's generally found profit policy ineffective in motivating contractors to invest in more productive plant and equipment." (3:68)

CAPITAL INVESTMENT TRENDS

In order to gain further insight into the relationship between profit and capital investment, we examined a number of statistical bases. These served not only to document investment trends of the defense industry but also identify significant correlations. We first examined net book value of tangible capital assets of 15 defense contractors as reported on CAS Board Forms-CMF for the period 1978 to 1982 (see Exhibit 20). All but one of these contractors had been part of the Profit '76 database. There were a total of 45 business segments included in this examination. These results demonstrated that there has been significant investment in capital assets during this period. Overall, capital investment of these contractors increased from $1.4 billion in 1977 to an estimated $4.1 billion for 1982 (193% increase). Moreover, these increases were noticeable to varying degrees for each of these contractors.

We correlated this data with statistics recently published by the Aerospace Industries Association. They revealed that investment in new plant and equipment during 1977-1982 has increased in a number of industry sectors, as shown in Exhibit 21.

Exhibit 21
New Plant and Equipment Expenditures
1977 - 1982
($ Billion)

	1977	1978	1979	1980	1981	Estimate 1982
Nonfarm Business	$198.1	$231.2	$270.5	$295.6	$321.5	$345.1
All Manufacturing	69.2	79.7	98.7	115.8	126.8	136.8
Durable Goods	34.0	40.4	51.1	58.9	61.8	67.2
Aerospace	2.0	3.2	5.3	7.0	6.4	7.3

Source: Aerospace Facts and Figures 1982/1983 (2:148)

Exhibit 22
Comparative Analyses of Defense Business Segment Statistics
Selected Aerospace Contractors
1981

Contractor	As Percentage of Corporate Total		
	Operating Revenue	Operating Profit	Capital Expenditures
A	47%	53%	39%
B	21	42	31
C	77	128 *	32
D	27	25	21
E	58	62	38
F	97	97	100
G	38	25	24
H	56	50	37
I	11	10	9
J	100	100	100
K	62	126	47
L	58	49	18
M	53	68	50
N (Not Available)			
O	23	45	31
1981 Weighted Average	40%	41%	29%
1979 Weighted Average	35%	30%	29%

*Percentages greater than 100% would indicate an operating loss from commercial related segments

Source: Corporate Financial Statements for 1981

As a percentage increase over 1977, there was more investment in the aerospace sector (265%) than in others (average approximately 90%). The comparability of percentage increases was somewhat distorted by the size of capital investment among these sectors, but there was no doubt that the aerospace sector's results were significant and correlate highly with net book value statistics previously shown.

We further isolated investment patterns by examining the published corporate financial statements for the 15 defense contractors, shown in Exhibit 20. In most cases, these financial statements displayed corporate data on a segment-by-segment basis. Thus, we were also able to discern differences in investment patterns between commercial and defense business segments. The results, summarized in Exhibit 22, also confirmed that there has been large capital investment within the aerospace industry. The increase, however, was highly correlative to increases in the sales base. We observed that for 10 of 14 corporations the proportionate share of capital expenditures for defense business segments was less than the proportionate share of defense related operating revenue, 12 of 14 for operating profit. As a percentage of sales in 1979 and 1981, capital expenditures of defense business segments was 4% but approximately 7% for commercial segments. This raised doubt concerning the existing relationships between the current profit policy and capital investment in the defense industry.

CAPITAL INVESTMENT INCENTIVES

Under DPC 76-3, the specific inducements for capital investment were embodied in (1) recognizing the cost of money on facilities capital (i.e., CAS 414) as a contract cost and (2) the capital employed profit factor. Both were directly tied to contractor facilities capital and were designed to represent specific and tangible reward for investment. In analyzing the effectiveness of these factors, it is important first to understand how they were applied.

Cost of Money

The cost of money was computed using CAS Board Form-CMF. The total average net book value of business segment assets was distributed to cost pools in a manner similar to overhead. Those assets which could be specifically assigned to an overhead pool were directly distributed. The balance of undistributed capital assets was then allocated in a systematic manner to the same overhead pools. Our review disclosed that for the 15 contractors surveyed, 37% of total assets were assigned to engineering pools, 50% to manufacturing pools, and 13% to G&A pools. Next, the asset balances were multiplied by the Treasury Rate to compute the cost of money for the accounting period. Finally, the cost of money was then divided by the overhead allocation bases to compute the cost of money factors which would then be applied on a contract-by-contract basis. The example below will illustrate this process.

Assume:

Treasury Rate	15%
Total Average Net Book Value - 198X	$10 Million
Engineering Direct Labor Base	$90 Million
Manufacturing Direct Labor Base	$75 Million
G&A Total Cost Input Base	$600 Million

	Engineering	Manufacturing	G&A	Total
Assignment of Assets:				
Direct Distribution	$1,000K	$3,000K	$1,000K	$ 5,000K
Allocation of Undistributed	2,000K	2,000K	1,000K	5,000K
Total Assignment	3,000K	5,000K	2,000K	10,000K
Treasury Rate	15%	15%	15%	15%
Cost of Money	$ 450K	$ 750K	$ 300K	$ 1,500K
Divided by Overhead Allocation Base	$90,000K	$75,000K	$600,000K	
Cost of Money Factor	.5%	1.0%	.05%	

These cost of money factors would be applied to the overhead allocation bases for the year. For example, for every $1 of engineering direct labor there would be .5% added for cost of money. It is very important to note that the cost of money distribution (and capital employed distribution) was principally allocated to direct labor.

Capital Employed Profit

The amount of capital employed for any given contract was determined by using the above process but in reverse. This was accomplished by using DD Form 1861 (Contract Facilities Capital and Cost of Money). The total amount of cost of money allocated to a contract was divided by the Treasury Rate. The resultant amount represented capital employed on an individual contract. This amount was then multiplied by the capital employed profit factor to yield capital employed profit. An example is presented on the next page.

	Contract A
Cost of Money	$ 75,000
Divided by Treasury Rate	15%
Capital Employed	$500,000
Profit Factor (Range 6-10%)	7%
Capital Employed Profit	$ 35,000

Overall, the intent of DPC 76-3 was to have capital employed profit represent 10% of total profit. By raising the profit range from 6-10% to 16-20% under DAC 76-23, this was intended to represent 17% of total profit. However, it must be noted that under DAC 76-23 (current Weighted Guidelines method)

only manufacturing related contracts were to receive capital employed profit. R&D and service contracts did not receive capital employed profit and cost of money was offset dollar-for-dollar.

COST OF MONEY

The amount of cost of money included in the negotiated profit on AFSC contracts during 1977-1981 varied according to the amount of capital employed and the Treasury Rate which rose from roughly 8% in 1977 to almost 15% in 1981. See Exhibit 23.

Exhibit 23
Cost of Money
Negotiated Profit on AFSC Contracts
1977-1981

	As a Percentage of Total Cost				
	1977	1978	1979	1980	1981
FFP	.5%	.9%	.7%	.8%	1.3%
FPI	.9	.9	.8	1.0	1.2
CPIF	.7	.8	1.1	1.1	1.1
CPFF	1.0	.8	1.0	1.1	1.8
Weighted Average	.8%	.9%	.9%	1.0%	1.3%

Source: DOD DD Form 1499 Database

The reason why there was proportionately more cost of money on cost type contracts is because such contracts are labor intensive. As noted in the previous illustration, cost of money is principally tied to direct labor.

The amount of cost of money actually paid to defense contractors was significantly changed under DAC 76-23. Prior to this policy, the Weighted Guidelines offset for cost of money on all contracts was included in the 30% reduction from CITP (Treasury Rate was 8% at this time). Under DAC 76-23, there was a dollar-for-dollar offset for R&D and service contracts, instead of the 30% CITP reduction. When recognizing that the Treasury Rate has almost doubled since DPC 76-3, the new policy would result in a greater offset for cost of money under DAC 76-23 for R&D and service contracts than would have occurred under DPC 76-3. The significance in this change lies in the structure for allocating facilities capital. As will be seen later in this section, there now is less profit recognition under DAC 76-23 for capital investment.

CAPITAL EMPLOYED

We next turned to an examination of the capital employed profit factor. DPC 76-3 redistributed profit factors such that 10% of the total profit would be based on capital employed. In DAC 76-23, the relative importance of this factor was increased to 17%. The actual capital employed profit, as well as the relative importance, for the 1977-1981 period are shown in Exhibit 24.

Exhibit 24
Capital Employed Profit
As Percentage of Total Profit Objective on AFSC Contracts
1977-1981

	As a Percentage of Total Cost				
	1977	1978	1979	1980	1981
FFP	.5%	.8%	.7%	.8%	1.5%
FPI	.9	.9	.8	.9	.8
CPIF	.7	.8	.9	.9	.8
CPFF	.9	.7	.8	.5	.3
Weighted Average	.8%	.8%	.8%	.7%	1.0%
Percent of Total Profit	8%	8%	7%	7%	9%

Source: DOD DD Form 1499 Database

The reason why the percentages were far below the desired objective of 17% in 1980 and 1981 was because fewer contracts qualified for the capital employed factor. Under DPC 76-3 all contracts qualified for the capital employed factor; however, only manufacturing contracts qualified for this factor under DAC 76-23. The resultant impact was significant as shown in Exhibit 25.

Exhibit 25
Allocated vs Recognized Capital Employed
Based on Profit Objectives on AFSC Contracts
1977-1981
($ Million)

	Allocated	Recognized	Percent Recognized
1977	$138	$138	100%
1978	191	191	100
1979	266	266	100
1980	286	267	93
1981	205	122	60

What increases might have been made to the capital employed factors under DAC 76-23 (from 6-10% to 16-20%) were offset by decreases in the amount of recognized capital employed. A more detailed examination of capital recognized in 1980 and 1981 by contract type is shown in Exhibit 26.

Exhibit 26
Allocated vs Recognized Capital Employed
Based on Profit Objectives on AFSC Contracts
By Contract Type
1980 and 1981

	FFP	FPI	CPIF	CPFF	TOTAL
1980	91%	94%	99%	52%	93%
1981	80	56	51	9	60

EVALUATION

In spite of the increases in capital investment, there were few who would link them to the current profit policy and fewer still who would believe that they have caused the higher productivity to yield lower unit costs. This, no doubt, is why the majority concluded that the profit policies of DPC 76-3 and DAC 76-23 have not worked. The most telling statistic is the relationship between labor and facilities capital during 1977-1981. It could be assumed that, if productivity gains were to be achieved though greater infusion of capital, it would be visible in the amount of labor applied to defense contracts. Capital would more likely be substituted for labor. Yet, our analysis disclosed no reduction in direct labor and no increase in facilities capital in the performance of defense contracts. This may have been caused, in part, by the fact that capital employed received less profit than labor, under DPC 76-3. See Exhibit 27.

Exhibit 27
Direct Labor vs Capital Employed on AFSC Contracts
As a Percentage of Contract Costs
1977-1981

	Direct Labor	Capital Employed
1977	19.5%	10.1%
1978	20.6	10.6
1979	21.9	9.4
1980	20.4	9.1
1981	21.1	10.2

Source: DOD DD Form 1499 database

We believe the disenchantment with DPC 76-3 and DAC 76-23 was not rooted in the desired objective of these policies, but rather it was traceable to the structure created to achieve them. The incentives have not produced the capital investment needed because they were too tangential to be credible. There were two specific structural problems:

- The shift in relative mix between CITP, risk, and capital employed was too insignificant to induce defense contractors toward capital investment. Furthermore, the capital employed profit factor was too small. This was confirmed in our opinion survey where 52% found the factor to be insufficient (versus 21% who did not). The Profit '76 study team recognized that a profit factor of 6-10% would have to be increased after the impact of DPC 76-3 could be evaluated. This factor was increased to 16-20% in DAC 76-23, but this proved to be a zero-sum gain overall because capital employed profit could not be applied to R&D or service contracts.

- The amount of capital employed computed under Weighted Guidelines for a given contract was simply a mathematical pro rata share of a business segment's total capital assets which may or may not be used in the performance of a given contract. Thus, a contractor's recovery of investment through capital employed profit was dependent upon how this factor was treated by all contracting officers. To the extent that various contracts may have been regarded as R&D or services (i.e., not capital intensive), the full effect of capital employed profit would be diluted. A tremendous disparity exists because R&D and service contracts are labor intensive, yet direct labor is the principal basis upon which capital employed is distributed at the business segment level. Therefore, it was highly doubtful that the capital employed factor was of much significance in corporate capital investment decisions.

SUGGESTED ALTERNATIVES FOR IMPROVEMENT

. There have been a number of alternatives suggested or already implemented on the problem of inducing capital investments. Some of these fall outside the profit policy, such as multi-year contracting, improved contract financing, TECH MOD program, capital investment indemnification, value engineering, etc. These programs are consistent with the opinions expressed in our survey where 73% believe that profit policy inducements are effective only if combined with other incentives (versus 10% who did not). Other survey results are as follows:

	Agree	Disagree	No Opinion
The best way to induce contractor investment in capital assets is to change the relative importance of profit factors within Weighted Guidelines.	15%	51%	34%
The best way to induce contractor investment in capital assets is to increase the overall profitability of defense work.	67%	21%	21%
Return on investment should be the major determinant of profit.	53%	29%	18%

While there has been growing support for a return on investment methodology, there are factors which mitigate against this method. In our survey there was an even split between those who felt a return on investment approach was administratively practical and those who did not. As attractive as a return on investment concept might seem to be, there are some serious problems. Return on investment is basically a balance sheet concept involving plant-wide considerations. We normally award contracts individually without regard to plant-wide capital employment. The critical problem with return on investment is the determination of true capital employment on a contract-by-contract basis. Many assets are used on multiple product lines. The greater diversification of product lines and numbers of contracts within a profit center, the more obscured this relationship becomes. Unless capital investment was accurately assignable to specific contracts, the structural problems noted above would not be overcome.

The "British method" of employing return on investment for profit has been suggested as a possible alternative for the U. S. to adopt. There are several distinguishing features between British and U. S. acquisition policies that render their profit system inappropriate for the U. S. The British defense industry is characterized by few major suppliers (concerted effort toward consolidation) and no competition (contracts are allocated among suppliers). Under this method, they annually compute a return-on-sales profit rate by applying a preordained return on investment to the previous year's average asset balance and then dividing this amount by the previous year's total production costs. This profit rate is applied to contracts awarded in the current year. If there is an increase in production costs over the previous year, the contractor enjoys a windfall profit. If production costs are less, then a loss of profit would be incurred. The influence of return on investment in controlling costs under the "British method" is doubtful.

A return on investment approach was previously tested by DOD in 1972 through DPC 107, but this method failed. DOD had attempted to introduce use of operating and facilities capital into the profit equation. Operating capital was defined as net current assets (current assets - current liabilities). Facilities capital was defined as net tangible capital assets (capital assets acquisition value - accumulated depreciation). The profit

objective under DPC 107, however, was not completely based on return on investment. It was a hybrid method which took into account other variables such as technical effort and contract risk but at considerably reduced amounts. The method was, nevertheless, complex and required many computations (five forms were used). A simplified summary of the method is shown below.

Computing Profit Under DPC 107

ITEM	FACTOR	PROFIT RATE
1	Contractor Input to Total Performance	XX%
2	Cost Risk	XX
3	Cost Based Profit Objective (1 + 2)	XX%
4	Contract Capital Turnover Rate	
5	Contract Capital Index	XX
6	Capital Adjusted Profit Objective (5 + 50% of 3)	XX%

DPC 107 was tested on a voluntary basis when requested by the contractor. There were few participants and, ultimately, it was withdrawn. The reasons for its failure were (1) the method was far too complex, (2) there was little appreciable difference in profits, and (3) low capital intensive contractors (or profit centers) were penalized.

Many suggested a higher degree of importance for capital employed than the 17% structured under the current Weighted Guidelines. This would come from corresponding reductions in the amount attributable to CITP. Such a shift in weight from CITP to capital employed would both reduce the association between profit and cost, a long-standing criticism of DOD's profit policy, and provide more return for capital invested. This method, however, would not overcome many of the structural problems in the DOD profit policy.

Another suggested inducement was to provide additional profit for future investments that are designed to enhance productivity. This method, much like the investment tax credit used by the Internal Revenue Service, would employ a special additive profit factor in the Weighted Guidelines (above capital employed profit). As part of a price proposal, the contractor would identify planned specific capital investments necessary for contract performance and their relation to productivity enhancing programs. The contracting officer would then award additional profit, within the constraints established by DOD. This method would provide more specific recognition of capital employed. Another approach to this alternative would be to establish this additive factor on a plant-wide basis. This may be more suitable in cases where capital investments (e.g., facilities) are to be used on several programs.

All of these suggestions have advantages and disadvantages. In our judgment, the most productive approach would be a method which better ties profit for capital employed to assets used in the performance of government contracts. Unless there is a tangible, credible, and direct structure of incentivizing investment, the profit policy will fail as a stimulus.

SUMMARY

Our study revealed that capital investment within the defense industry has increased. Yet, we also found that such investment was still proportionately less than that attained in the commercial sector. This was most evident for those major corporations simultaneously engaged in both defense and commercial business.

Overall, we concluded that profit, in and of itself, will not induce capital investment. In spite of the DPC 76-3 revisions emanating from the Profit '76 study, capital investment as a percentage of total cost, did not change during the 1977-1981 period. Thus, the assumption that higher return on sales will stimulate investment on defense contracts was not supported by actual experience. Profits were higher during 1977-1981, but relative investment did not change.

The concept of DPC 76-3 was generally sound in that, all things being equal, profits would increase only if capital investment increased. The structure designed to achieve this concept, however, was flawed. The capital employed profit factor was far too small, and the method of establishing capital employed on a given contract was too indirect. The problems with DPC 76-3 were further aggravated by DAC 76-23, which has resulted in only 60% of the assets assignable to defense contracts being recognized for cost of money and capital employed profit in 1981. Unless rescinded, DAC 76-23 will continue to be an obstacle to capital investment.

There have been a number of alternatives suggested to provide a more direct simulus between profit and investment. Many have advocated a return on investment approach. While this approach is conceptually attractive, there are major practical problems (e.g., determination of actual capital used on a given contract). Other alternatives are available which deserve consideration, but there must be a recognition that these should be combined with other capital investment incentives outside the profit policy.

. Specific actions in regard to these findings are presented in Part VII of this report.

PART V

PROFIT AND PRODUCTIVITY

It has been widely accepted that a cost-based profit methodology serves as a major disincentive for productivity improvements. Simply put, a contractor would be very reluctant to lower unit costs, if such cost reductions would result in lower profits. Under this arrangement, the government would receive the full benefit of productivity improvements, and the contractor would receive no benefit. The Profit '76 study team fully recognized this problem and, as a result, introduced the special productivity factor in the Weighted Guidelines. This section examines this factor and how well it has worked.

SPECIAL PRODUCTIVITY FACTOR

DOD created the special productivity factor in September 1976, under DPC 76-3. According to DAR 3-808.8, its purpose was "to mitigate the loss of profit dollars opportunity that occurs when costs are reduced due to productivity gains." Thus, the special productivity factor was a mechanism within the Weighted Guidelines where contractors could share in the benefits of productivity gains. The specific applicability criteria were as follows:

- Involves a follow-on production contract.
- Reliable actual cost data is available.
- Configuration changes have not obscured cost comparisons.

The DAR 3-808.8 provisions further specified the method to be used in calculating the special productivity factor. Essentially, contractors would receive additional profit on verifiable reductions in follow-on unit costs which were caused by productivity gains (economies of scale did not qualify as productivity gain) at the base profit objective rate. The guidance, however, did not specify a time period over which the productivity gain would be recognized.

PRACTICAL APPLICATION

Our examination of the profit experience since DAC 76-3 disclosed that the special productivity factor has been rarely used in practice. We found only six instances where it was used in AFSC during the three-year period 1979 to 1981. We learned that the other services have used this factor even less. Our Acquisition Personnel Opinion Survey further disclosed the following:

	Agree	Disagree	No Opinion
The special productivity factor (line 19 in WGL) is a viable tool for encouraging and rewarding productivity improvements.	27%	42%	31%
The special productivity factor is administratively too difficult to apply.	43%	23%	34%

In order to gain a better insight to the problems associated with this factor, we solicited specific comments from our field contracting offices and industry participants at the AFSC/Industry Executive Conference held in June 1982. Most agreed that the special productivity factor was conceptually sound, and few could find fault with the DAR 3-808.8 implementing instructions or criteria. Most of the problems were attributable to practical application. Some specific comments received from our field contracting offices and industry respondents are summarized below.

- Industry's principal criticism was that contracting officers provide more profit for productivity but at the expense of other profit factors. The special productivity reward should be regarded as outside the profit factors attributable to the instant contract (e.g., technical effort, risk, capital employed). All things being equal, a contract which uses the special productivity factor should receive a higher profit than a contract which does not.

- The extent to which productivity gains were to be documented (or proven) posed a serious obstacle. Closely related to this was the difficulty of objectively measuring productivity gains.

- The special productivity factor has been viewed as being applicable only to the instant contract. It could not be carried forward enough on future contracts to make this a worthwhile profit factor.

- Follow-on buys on production contracts are often consummated prior to completion of the current production effort. Because the cost data would be incomplete, it would make the application of the special productivity factor even more difficult.

- Industry perceives a reluctance of contracting officers to be willing to consider additional profit for productivity. Some suggested that this be made an item in the RFP in order to give visible recognition to the government's intended use of this factor.

There appeared to be two other conceptual problems with the current policy on special productivity. First, under DAR 3-808.8 and more specifically the current weighted guidelines, the factor can only be applied to follow-on production contracts. We believed that contractors can achieve productivity improvements in other types of contracting situations. For example, the Weighted Guidelines do not now allow the special productivity factor on service-type contracts. Yet, there could be many areas where productivity gains could be achieved on the Test Range O&M contracts. The productivity

gains may not result from heavy capital investment, but they could nonetheless be achieved. The policy for restrictive application of this factor (limited to capital investments) may not be in DOD's best interests.

Second, the use of the special productivity factor has not been adequately integrated with other cost reducing incentives, such as Value Engineering and the Technical Modernization (TECHMOD) programs which also encourage contractors to lower unit costs. This is discussed in greater detail below.

CAPITAL INVESTMENT AND PRODUCTIVITY

The major determinant of capital investment is the expected return a contractor can realize. This is generally expressed as the discounted internal rate of return received from the net cash flow of attendant savings. An example will be used to demonstrate this concept. Assume that a $1 million capital asset will produce annual savings of $300,000 in production costs over a five-year period. It is understood that several other factors are involved (e.g., CAS 414, salvage value, taxes, etc.). This example is simplified only to demonstrate the basic concept. See Exhibit 28.

Exhibit 28
Discounted Cash Flow Analysis
At 15%

Year	Savings	Discount Factor	Discounted Cash Flow
1	$ 300,000	.8696	$ 260,870
2	300,000	.7561	226,843
3	300,000	.6575	197,255
4	300,000	.5717	171,526
5	300,000	.4972	149,153
Total	$1,500,000		$1,005,647

The net present value of the $300,000 annual savings in production costs exceeds the $1 million dollar investment. Thus, it would receive favorable consideration because it exceeds the 15% investment criterion. If annual savings were less than $300,000 or the investment criteria were higher than 15%, the present value would be less than $1 million and, therefore, not favorably considered.

Industry's main objection to programs to stimulate investment (like the special productivity factor) has been the government's failure to understand this basic model. DOD's profit policy will return lost profit, but the savings in production costs would be solely absorbed by the government. As can be discerned from the above model, if net cash flow from capital investment were restricted to profit, its present value would never exceed the initial investment. Thus, it is highly unlikely that capital investments for improving productivity would be undertaken in such circumstances.

Another problem area concerning capital investment and productivity is the relationship between capital investment and individual contracts. Many capital investments have a plant-wide savings potential. As such, they cannot be attributed to specific contracts, but are, instead, only relevant in the aggregate sense. In order to correct this problem, many have suggested to develop plant-wide shared savings agreements which are allocable to all contracts which benefit from the capital investment.

There is an apparent conflict between use of the special productivity factor and shared savings agreements. Some have argued that use of shared savings agreements would obviate the need for the special productivity factor. We believe these claims are unfounded. First, not all productivity gains are attributable to capital investment. They could result from several actions ranging from industry cost reduction programs to changes in the processes used to produce goods or services. Second, shared savings agreements tend to focus on savings in production cost. They do not generally return lost profit, as in the case of the special productivity factor. The reduction of long-term profit caused by cost reductions would still represent a significant criterion in capital investment decisions.

The special productivity factor and shared savings agreements are compatible programs. Properly employed, their combination could provide a credible stimulus for capital investment. While shared savings agreements should be applied on a plant-wide basis, the special productivity profit factor should continue to be applied to individual contracting situations. While one focuses on cost, the other focuses on profit (which is influenced by other factors such as technical, contract risk, etc.).

SUMMARY

The special productivity factor was created to remove a major disincentive for productivity enhancements by the defense industry: lost profit. Yet, this factor has not been used, except for a few cases. The reason for its disuse does not lie in the DAR coverage but, rather, in its practical application. The difficulty in measuring productivity is the heart of the problem. However, there are other significant practical problems, as well. The factor is applied only to the instant contract, even though the productivity increase will provide benefits well into the future. Furthermore, industry does not perceive a genuine interest by the government to use the factor.

The special productivity factor needs to be revitalized as a contracting tool. It is highly compatible with other DOD initiatives such as TECH MOD, shared savings agreements, Value Engineering, etc.

Specific findings and recommendations are contained in Part VII.

PART VI

OTHER PROFIT RELATED PROBLEMS

Up to now, we have discussed the relationships between the DOD profit policy and profitability, capital investment, and productivity. Our examination of profit revealed a number of other problems with a broad impact. In this section, we will review a few of these remaining problems.

PROFIT AND TIME VALUE OF MONEY

The impact of the time value of money on realized profits was a major issue which has become more visible because of high interest rates. There is a natural erosion of profit inherent in the methods of computing and paying profit. The example, shown below as Exhibit 29, demonstrates the impact of the time value of money.

Exhibit 29
Impact of Time Value of Money on Profit

	YEAR 1	YEAR 2	YEAR 3	YEAR 4	TOTAL
Projected Cost (Constant $)	$1,000	$1,000	$1,000	$1,000	$4,000
Inflation Index (15%)	1.000	1.150	1.322	1.521	
Escalated Cost Projection	$1,000	$1,150	$1,322	$1,521	$4,993
Profit Rate	10%	10%	10%	10%	10%
Profit	$ 100	$ 115	$ 132	$ 152	$ 499

The projected profit on this contract is $499 or 10% of total costs (including escalation). This profit amount, however, can be significantly reduced in real terms when considering the actual timing of profit payments. If, for example, the end item was delivered and invoiced on the last day of the fourth year, the present value of the $499 profit payment would be reduced to $328 at a 15% discount rate, which would be a 34% decrement in realized profit. This amount would be appreciably less than on a contract with an identical cost profile but whose deliveries begin much earlier in the course of contract performance.

The impact of inflation on profits, particularly on long-term contracts, is a serious problem. It is primarily caused by applying a rigid structure for establishing profit objectives (i.e., Weighted Guidelines) on contracting situations which are affected by many variables. There are two alternatives to improving this situation.

- Provide more favorable contract financing provisions on long-term contracts which include profit payments for completion of significant contract requirements. This could be accomplished by revising the DAR Appendix E coverage on milestone billings to include profit or creating a provision for interim acceptances.

- Establish a provision within the Weighted Guidelines method to take into account situations where profit payments occur significantly late in the period of performance. This provision should be restricted to long-term contracts. Because some degradation is considered normal, even in commercial enterprise, DOD should apply this method only to situations where the degradation is significant (e.g., more than 20%).

SIMPLIFICATION OF WEIGHTED GUIDELINES

In 1976, 66% of those surveyed believed they had a good understanding of the Weighted Guidelines (versus 18% who did not). The results were slightly different in 1982 (54% versus 27%). Yet, we found that 51% believed the Weighted Guidelines format should be simplified (versus 18% who did not).

One of the most confusing elements of profit is the provision on cost of money payments on facilities capital. The policies on this element have been widely misunderstood, and the underlying rationale becomes increasingly obscured with passage of time. Opinions on cost of money were very strong, as evidenced in our survey.

	Agree	Disagree	No Opinion
The method for offsetting facilities capital cost of money needs to be simplified.	67%	9%	24%

The rationale and method of implementing CAS 414 was probably widely understood at the time of Profit '76 and DPC 76-3. Up to then, cost of money had received implicit recognition in the Weighted Guidelines, but under DPC 76-3, it was to be explicitly recognized as a cost. In order to compensate for this shift and because the relative profit weights were unchanged by DPC 76-3 for administrative convenience, a decrement factor was necessary. In DPC 76-3 the decrement was computed by multiplying 70% times CITP. Under DAC 76-23 the decrement was computed by multiplying 30% times CITP and subtracting this from the total for manufacturing contracts, but not for R&D or service contracts. The profit on R&D and service contracts was to be offset dollar for dollar. As previously shown in Exhibit 5, the cumulative effect of these changes has been very confusing.

PROFIT ATTITUDES AND PERCEPTIONS

The final area we examined within the AFSC Profit Study '82 was the attitudes and perceptions of both government and industry toward DOD's profit policy. We believed the success of any policy would be primarily dependent upon its credibility. We included several questions on this topic within our Acquisition Personnel Opinion Survey.

	Agree	Disagree	No Opinion
The system puts much pressure on contracting officers to keep profits down.	58%	27%	15%
The Weighted Guidelines are used more as a crutch to justify the final negotiated price rather than as a tool to develop an appropriate profit.	46%	44%	10%
The government profit/fee objective is often dictated by management, regardless of the Weighted Guidelines computation.	61%	27%	12%

The first and second questions above were also included in the Profit '76 survey. We noted that there was little change in perceptions.

The professional literature was replete with similar sentiments. They believed that profit objectives were significantly influenced by factors outside the Weighted Guidelines method. The most frequently cited influence was management direction. The following passage from a research study for the National Defense University typifies industry's frustrations (7:30).

> Most believe the PCO does not determine the profit objective in keeping with the spirit of current DOD policy. Rather, industry managers believe many PCOs determine the profit objective a priori using subjective criteria and then assign weights on the DD Form 1547 to back into that profit objective.

These perceptions, whether real or imagined, must be corrected as a priority measure. The credibility of any DOD policy designed to encourage capital investment or induce productivity is entirely dependent upon its perception by contracting officers and industry.

SUMMARY

Specific findings and recommendations are contained in Part VII.

PART VII

FINDINGS AND RECOMMENDATIONS

In the previous sections of this Summary Report, we examined a number of problems with the current DOD profit policy. We identified several areas where the profit policy is not responsive to today's business environment. The most significant conclusion was that the desired objectives of DPC 76-3 and DAC 76-23 were not achieved. The specific findings and recommendations of AFSC Profit Study '82 are described below.

FINDINGS

FINDING 1: BY ITSELF, PROFIT WILL NOT INDUCE CAPITAL INVESTMENT

The operating premise of the Profit '76 study team and the ensuing DPC 76-3 was that a higher return on sales for defense contracts would yield higher capital investment. The results of the AFSC Profit Study '82 raised doubt about this premise and the role of profit in capital investment. Profits on defense contracts for the 1977-1981 period increased and achieved reasonable comparability with FTC durable goods producers. Yet, capital investment for defense contracts was still proportionately less than in the commercial sector. It was particularly important to note that capital investment on defense contracts as a percentage of total contract costs did not change during the 1977-1981 period.

In our opinion, many within government and industry have expected too much from the DOD profit policy in inducing capital investment. Although it is an important factor in capital investment decisions, it does not rank as high as other criteria. By far, the greatest concern to industry is the expectation that the capital investment would be fully recovered, including a reasonable return. Other important criteria are competition, maintaining market shares, growth, technological advancement, etc.

Future decisions concerning the DOD profit policy must recognize that profit, in and of itself, will not cause capital investment. Other programs with a more direct stimulus on capital investment must be undertaken. Profit is still an important factor but only in a supporting role.

FINDING 2: THE STRUCTURE OF DPC 76-3 DID NOT ADEQUATELY REWARD CAPITAL INVESTMENT

The concept of DPC 76-3 was generally sound in that, all things being equal, profits would increase only if capital investment increased throughout a business segment. The structure designed to achieve this concept, however, did not adequately reward investment. The capital employed profit factor was far too small (as admitted by the Profit '76 study team) and the method of establishing capital employed on a given contract was based on an indirect allocation of assets. The greater the diversification of defense contracts, the less impact the capital employed factor would have in rewarding capital investment. This was particularly evident for large capital investments

specifically used on a single defense contract, where adequate return on this investment was dependent upon how all contracting officers rewarded capital employed on other contracts. DAC 76-23 increased the profit from 6-10% to 16-20% of capital employed in 1980, but this increase was negated by other structural changes in DAC 76-23.

FINDING 3: THE PROFIT POLICY CHANGES UNDER DAC 76-23 SIGNIFICANTLY REDUCED THE POTENTIAL IMPACT OF PROFIT ON CAPITAL INVESTMENT

The structural problems of DPC 76-3 were significantly magnified with promulgation of DAC 76-23. It resulted in a 40% reduction in the amount of capital employed being recognized on AFSC contracts in 1981. Under DPC 76-3 and DAC 76-23, cost of money and capital employed were allocated to defense contracts on the same basis as overhead. Therefore, they both tend to follow direct labor. The three-column approach in DAC 76-23 does not allow capital employed profit or cost of money on R&D and service contracts, normally labor intensive. Therefore, to the extent that a contractor has R&D and service contracts, business segment capital assets were not recognized for cost of money and capital employed profit. Our survey of 15 aerospace contractors disclosed that almost 40% of corporate assets had been assigned to engineering pools. This represents an extensive assignment of capital to R&D contracts. What capital investment motivation which may have existed under DPC 76-3 was significantly reduced under DAC 76-23.

R&D and service contracts are now treated with profit guidelines similar to that which existed prior to Profit '76. It is important to note, however, that the 5% profit factor for past performance was not reinstated. This resulted in the potential for lower profit rates, no cost of money, and no capital employed profit on R&D and Service type contracts. DAC 76-23 also developed two separate methods for offsetting cost of money (manufacturing vs. R&D and service contracts) with questionable rationale. While some adjustment to the profit policy was needed for those cases where contractors had little need for facilities capital investment, DAC 76-23 proved to be an ineffective method. The overall implementation of the profit policy under DAC 76-23 has been extremely confusing to both field contracting offices and industry.

FINDING 4: CITP FACTORS ARE NO LONGER RELEVANT TO TODAY'S BUSINESS ENVIRONMENT

The CITP profit factors on individual cost elements have remained unchanged since the inception of the Weighted Guidelines method in 1964. There was strong evidence which suggested that they are no longer relevant to today's contracting environment. For example, the 1-4% factor for material is too low, particularly when compared to the 6-8% factor for G&A which is a period cost.

FINDING 5: THE PROFIT POLICY CHANGES FOR CONTRACT RISK DID NOT PROVIDE A SIGNIFICANTLY GREATER DISTINCTION IN REALIZED PROFITS BETWEEN FIXED-PRICE AND COST TYPE CONTRACTS

The Profit '76 study team developed a policy which was designed to provide greater distinction in realized profits between fixed-price and cost type contracts. The profit factors for risk were changed under DPC 76-3 and again

under DAC 76-23. Our review disclosed, however, that not much increase in profit distinction was probably achieved as a result of these specific changes. If any distinction was achieved from DAC 76-23, it was a result of now treating R&D and service contracts with profit guidelines similar to that which existed prior to Profit '76. It was also apparent that the many changes in DOD's profit policy toward risk have caused much confusion for field contracting offices.

FINDING 6: RECOGNITION OF CAPITAL EMPLOYED PROFIT HAS NOT MOTIVATED CONTRACTOR INVESTMENT

During the period 1977-1981, capital employed profit never exceeded 9% of the total profit objective in AFSC contracts. Over 90% of the total profit objective was still based on cost (CITP and risk). The capital employed factor's influence on the total profit objective is much too insignificant to motivate a contractor to make capital investments. Coupled with the impact of DAC 76-23, we doubt that the capital employed profit factor has had any influence on contractor investment decisions.

FINDING 7: THE WEIGHTED GUIDELINES SPECIAL PRODUCTIVITY FACTOR HAS NOT BEEN USED

The special productivity factor was created to remove the major disincentive of lost profits from productivity increases. Yet, this factor has not been used, except for a few cases. The reason for its disuse does not lie in the DAR coverage but, rather, in its practical application. The difficulty in measuring and verifying productivity is the heart of the problem. However, there are other significant practical problems, as well. The factor has been regarded as applying only to the initial follow-on production contract, even though the productivity increase will provide benefits well into the future. We also do not believe this factor should have been excluded for R&D and service contracts.

FINDING 8: THE TIME VALUE OF MONEY SIGNIFICANTLY ERODES REAL PROFITS ON LONG-TERM CONTRACTS

Because there can be a considerable timing difference between the incurrence of cost (computational base for profit) and payment of profit, a significant erosion in real profit can occur on long-term contracts. This is caused by use of a cost-based profit system where the profit rate is evenly applied to all costs in the period of incurrence. If there is a wide difference between the periods of incurrence and profit payment, then the time value of money will have considerable impact on real profitability of long-term defense contracts. This erosion may have been considered normal when inflation was 6%, but when inflation rates are double-digit, it may greatly affect a contractor's willingness to accept defense contracts.

FINDING 9: THE WEIGHTED GUIDELINES METHODOLOGY HAS BECOME INCREASINGLY CONFUSING

Over half the people surveyed in this study felt that the WGL method needed to be simplified (versus 18% who did not). The two most confusing aspects were the cost of money offset methodology and the proper implementation of DAC 76-23. The cost of money offset was included in the 30% decrement

factor from CITP. While this factor may have been widely understood in 1976, its rationale has become obscured with the passage of time. It also lacks credibility because of fluctuations in the Treasury Rate which would have an impact on the 30% decrement factor (constant percentage). The differing treatments for offsetting the cost of money under DAC 76-23 have added to this confusion. Lastly, the ASPM No. 1 guidance for determining the profit objective is no longer applicable because it relates to pre-Profit '76 policies.

FINDING 10: DOD PROFIT POLICY LACKS CREDIBILITY

Defense contractors perceived that the Weighted Guidelines method is not the real determinant of profit. They felt that management direction has a greater impact on profit determination. This perception was also confirmed by government contracting personnel who shared the belief that profit is largely determined by management, regardless of Weighted Guidelines computations.

RECOMMENDATIONS

RECOMMENDATION 1: DOD MUST HAVE REALISTIC EXPECTATIONS OF THE TRUE RELATIONSHIP BETWEEN PROFIT POLICY AND CAPITAL INVESTMENT

The DOD profit policy must recognize that profit, in and of itself, cannot encourage contractor investment. Profit is only one of many factors which contribute to a corporate capital investment decision. Conceptually, the framework exists to use the profit policy as a motivator for capital investment and productivity improvements. However, there must be a recognition that profit policy must be combined with other capital investment incentives such as multiyear contracting, improved contract financing, TECH MOD, and shared savings agreements, etc.

DOD should clarify the function of profit on defense contracts. While capital investment may be a worthwhile subsidiary goal, its purpose should be directed toward rewarding management skill, assumption of risk, efficient employment of capital, and effective contract performance.

RECOMMENDATION 2: DOD SHOULD RESCIND DAC 76-23

For profit to be a motivator for capital investment, contractors must have an opportunity to recover the cost of money and capital employed profit for all the corporate capital assets. The indirect allocation method for capital employed necessitates a single profit methodology because capital investment decisions are normally made on a corporate basis, and all contracts must participate in the recovery of the cost of capital investment. Unless rescinded, DAC 76-23 will continue to be an obstacle to capital investment.

RECOMMENDATION 3: DOD SHOULD SUBSTANTIALLY REVISE THE CITP PROFIT FACTOR

The relative importance of CITP should be further reduced (e.g., to 40% of total profit) in favor of allowing tangible increases in capital employed. The individual factors should also be revised in order to be more responsive to today's business environment. The factor for material and subcontracts should be substantially increased from their present levels, and the profit attributable to G&A should be decreased. Furthermore, such a readjustment of CITP will increase the overall distinction between fixed-price and cost type contracts.

In order to eliminate the confusion surrounding CITP, a number of other revisions are necessary. First, DOD should establish a normal profit factor for each cost element (e.g., mid-point of range). The DAR 3-808 provisions should be expanded to provide guidance on appropriate profit weights for individual CITP elements. If circumstances warrant, contracting officers could still award higher or lower profit factors. This approach would add to the credibility of the Weighted Guidelines method by reducing the influence of management and make the practice of "backing-in" to profit rates less likely. Second, the 30% offset factor for cost of money (and CITP adjustment) should be eliminated. This could be accomplished by reducing the profit ranges for CITP.

22-859 O - 83 - 12

It should be noted that industry participants on the Blue Ribbon Panel agreed that the 30% offset factor should be eliminated but not at the expense of other profit factors. Their view was principally based on their disagreement with the concept of an offset factor, as established under DPC 76-3.

RECOMMENDATION 4: DOD SHOULD REVITALIZE THE SPECIAL PRODUCTIVITY FACTOR

In spite of its lack of use, we continue to believe that the special productivity factor is a fundamentally sound concept and worth keeping as an integral part of DOD's profit policy. It is very important to show industry that we have a mechanism within the weighted guidelines that returns lost profit caused by productivity gains. What is needed are credible, practical, and simple implementing procedures, as well as a better marketing effort by the acquisition community.

The special productivity factor needs to be revitalized as a contracting tool. It is highly compatible with other DOD initiatives such as TECH MOD, shared savings agreements, Value Engineering, etc. Properly employed, their combination could provide a credible stimulus for productivity. While shared savings agreements for cost reductions should be applied on a plant-wide basis, the impact on profit should continue to be applied to individual contracting situations using the special productivity factor. This factor should be allowed on production contracts beyond the instant contract.

RECOMMENDATION 5: DOD SHOULD DEVELOP POLICY TO ADDRESS THE IMPACT OF THE TIME VALUE OF MONEY ON REALIZED PROFITS

The impact of inflation on profit, particularly on long-term contracts, is a serious problem. It is primarily caused by applying the structure for establishing profit objectives where significant timing differences can exist between cost incurrence and profit payment. There are two alternatives in improving this situation.

- Provide more favorable contract financing provisions on long-term contracts which include profit payments for completion of significant contract requirements. This could be accomplished by revising the DAR Appendix E coverage on milestone billings to include profit or creating a provision for interim acceptances. (PREFERRED APPROACH)

- Establish a provision within the Weighted Guidelines method to take into account situations where profit payments occur significantly later in the period of performance. This provision should be restricted to long-term contracts. Because some degradation is considered normal, even in commercial enterprise, DOD should apply this method only to situations where the degradation is significant (e.g., more than 20%).

RECOMMENDATION 6: DOD SHOULD SIMPLIFY THE WGL IMPLEMENTATION

The Weighted Guidelines method must be simplified in order to increase its usefulness and credibility. Some of our suggestions toward simplification were included in the previous recommendations such as, eliminating the multiple column approach and the cost of money offset factor.

Other suggestions include reducing the number of CITP factors (e.g., combine indirect expenses), simplifying risk factors, and removing special factors which do not contribute to DOD profit policy. It is also essential that ASPM 1 be revised to provide current guidance on the profit policy.

RECOMMENDATION 7: THE CONTRACTING COMMUNITY MUST RESTORE CREDIBILITY TO THE DOD PROFIT POLICY

Credibility in the DOD profit policy must be restored. This can be structurally achieved by implementing the above recommendations. However, confidence will not be completely restored until the contracting community convinces industry that profits are not dictated by influences outside the profit policy. The perception that the Weighted Guidelines are "backed into" must be changed. The contracting officer's rationale supporting profit objectives should be disclosed.

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APPENDIX A

SELECTED LITERATURE ABSTRACTS

Abstainer

The inclusion of selected items of literature in this section does not indicate our concurrence with their findings and recommendations. They are presented, instead, to document the breadth and scope of the AFSC Profit Study '82.

LITERATURE ABSTRACT

TITLE: 'Recognizing the Cost of Invested Capital in Government Contracting

AUTHORS: Rein Able and Paul McClenon

PUBLICATION: GAO Review, Winter, 1977, Vol. 12

OVERVIEW: This article gives a brief account of the development of CAS 414--Cost of Money as an Element of the Cost of Facilities Capital (FCCM). It also examines some of the issues that arise as a result of employing a cost-based profit policy in a period of inflation.

MAJOR FINDINGS/POINTS:

1. "The lack of explicit recognition of cost of capital has tended to act as an effective deterrent to the necessary investment by contractors. Implementation of Standard No. 414 and the new profit policy adopted by the Department of Defense should remove the deterrent."

2. The DOD anticipated that, in the aggregate, the increased cost from recognizing FCCM as an allowable cost would be offset by a decrease in negotiated profit of roughly the same amount. It further anticipated that the profit objectives for capital intensive efforts would be relatively higher than the profit objectives for labor intensive efforts.

LITERATURE ABSTRACT

TITLE: "DOD Profit Policy - Its Effectiveness--The Contracting Officer's View"

AUTHOR: Thomas Perry Anderson

PUBLICATION: Master's Thesis, Naval Post Graduate School, Monterey, California, 1980

OVERVIEW: The purpose of the thesis was to obtain the opinions of DOD procuring contracting officers regarding their perceptions of the effectiveness of DOD's profit policy. The opinions were gathered by questionnaires sent to 25 DOD buying commands.

MAJOR FINDINGS/POINTS:

1. DOD profit policy has been ineffective in encouraging contractor investment in labor-saving capital equipment.

2. The facilities capital and productivity sections of WGL were having little effect on contractor investment.

3. Program instability and the impact of socio-economic programs on the contracting process were major contributors to profit policy's ineffectiveness.

4. Profit policy is not an item of great concern in the buying commands that responded to the questionnaire.

LITERATURE ABSTRACT

TITLE: "DOD Revamping Its Profit Policies for Defense Contractors"

AUTHOR: Dale R. Babione, Deputy Assistant Secretary of Defense (Procurement),OASD(I&L)

PUBLICATION: Defense Management Journal, Vol. 12, No. 4, October 1976

OVERVIEW: Article previews policy changes resulting from the Profit '76 study.

MAJOR FINDINGS/POINTS:

1. The defense industrial base was suffering from low level of investment which was attributable to low profitability of defense contracts.

2. Profit '76 dispelled some time honored concepts about profit on DOD contracts.

   a. There was very little difference in profit between cost reimbursement and fixed-price type contracts.

   b. Contractors actually earn less profit than the amounts negotiated because of unallowable costs (profit erosion was roughly 25 percent).

   c. Government-owned equipment has little impact on ROI.

   d. Contractors invest $.25 per sales dollar on commercial business and $.10 on government business.

SUMMARY:

1. Weighted guidelines would continue as basic approach.

2. The cost base would receive less emphasis and risk factor would receive more emphasis.

3. Contractor past performance would be dropped as profit factor.

4. In addition to profit policy changes, other techniques would receive more emphasis.

   a. Special termination buy-back provision.

   b. Multiyear contracting.

   c. Award fee focusing on investment.

   d. Shared savings from investment.

LITERATURE ABSTRACT

TITLE: "A Study of the Effect of Economic and Inflation Related Factors Upon Business Firms Acting as Suppliers to the United States Air Force"

AUTHOR: Dr. John G. Beverly, Dr. Frank J. Bonello, and Dr. William I. Davisson.

PUBLICATION: Contracted Study for the Air Force conducted by the University of Notre Dame, Notre Dame, Indiana.

OVERVIEW: The study was conducted by professors and associate professors of economics and accountancy of the University of Notre Dame. The major thrust was directed toward providing information which would aid the Air Force in its acquisition process.

MAJOR FINDINGS/POINTS:

1. No single, simple statement can be made regarding the relationship between government and Air Force sales on the one hand and profitability on the other.

2. The greater the proportion of Air Force sales, the higher the rate of return on investment if the sample is restricted to SIC codes 3000 to 3999.

3. There is no significant relationship between government sales or Air Force sales and the cost of goods sold ratio.

CONCLUSIONS:

1. No statistically significant relationship exists between degree of Air Force sales and profitability.

2. No statistically significant relationship exists between degree of Air Force sales and efficiency.

3. Air Force acquisition procedures create no differences between defense and nondefense contractors.

4. There has been no consistent and significant difference found in profitability of civilian as compared to defense contracting firms.

LITERATURE ABSTRACT

TITLE: "Problems with the New Department of Defense Profit Policy"

AUTHOR: Robert J. Blair

PUBLICATION: Air Force Institute of Technology Master's Thesis, December 1976

OVERVIEW: The objective of this study was to identify potential problem areas that might hinder successful implementation of the new DOD profit policy resulting from "Profit '76."

MAJOR FINDINGS/POINTS:

Interviews with 40 acquisition personnel at Headquarters Aeronautical Systems Division, during which responses to 44 preselected questions were obtained, revealed misgivings in the following areas:

(1) Calculation of Facilities Capital Factors
(2) Contractor Assumption of Investment Risk
(3) Cost of Facilities Capital Money
(4) Productivity Reward

RECOMMENDATION:

Those interviewed perceived that the new policy would have limited success in motivating defense contractors to invest in cost reducing capital equipment.

LITERATURE ABSTRACT

TITLE: "Calculation of Profit on Negotiated Contracts"

AUTHOR: Lt Col Douglas H. Diamond, USAF, and Major Robert J. Cantin, USAF

PUBLICATION: USAF Aeronautical Systems Division Research Project, November 1981

OVERVIEW: This report questions whether attempts by the government to encourage contractor investment in capital equipment have been effective.

MAJOR FINDINGS/POINTS:

1. Contractors do not see the increased consideration given to facilities capital employed as an effective investment incentive.

2. The uncertainty of follow-on contracts, as well as the possibility of early termination, makes it impossible to predict whether the cost of an investment will ever be recovered. Termination protection and multiyear contracting are seen as ways to improve this situation.

3. Contractors make more profit on commercial contracts than they do on government contracts.

4. Contractors do not believe that government contracting officers calculate profit objectives in the way intended by the weighted guidelines. Rather, they believe that the contracting officers start with a predetermined profit objective based on historical data or other factors, and then "back-in" to the weighted guidelines method.

5. Progress payments should be increased and interest should be an allowable cost.

6. Contractors should be allowed to retain a greater share of cost savings in order to have an incentive to produce such savings.

RECOMMENDATIONS:

1. Programs such as Technology Modernization and Manufacturing Technology will greatly improve capital investment, and together with the revised profit policy, will help achieve the national goal of improved productivity.

2. The increased emphasis on the part of the government to improve productivity by introducing new programs such as MANTECH may justify conducting another survey to assess their effectiveness.

LITERATURE ABSTRACT

TITLE: "DOD Profit Policy and Capital Investment"

AUTHORS: Issue Analysis Team No. 6a

PUBLICATION: Defense Management Issue Analysis, Research Report, National Defense University, May 1980

OVERVIEW: Research report evaluates effectiveness of Profit '76 in achieving increased capital investment. Report also summarizes major studies performed by GAO, OFPP, and DOD since the Profit '76 study.

MAJOR FINDINGS/POINTS:

1. There are conflicting DOD objectives in the profit study regarding investment.

   a. The profic policy is aimed at stimulating investment; however, the heaviest weightings are still for cost. This encourages "make" decisions instead of "buy" decisions.

   b. The investment and productivity profit bases are rational but are insufficient in themselves to stimulate investment.

   c. Productivity improvements are discouraged because they lower the cost of follow-on orders and, thus, the profit on follow-on orders.

2. There are barriers to facility investment which are not being overcome by the inducements in the profit policy.

   a. Profit is too subjective a tool to be of any substantive benefit.

   b. The profit policy is sometimes not put into practice by contracting officers.

   c. Major barriers include defense business instability, low production quantities, etc.

RECOMMENDATIONS:

1. DOD should review and publicly identify the objectives of the profit policy.

2. DOD should give major emphasis to ensuring its profit policy is implemented.

3. DOD should attempt to reduce the barriers to facility investment that are controllable (e.g., adjust cost of money rate to be more realistic, multiyear contracting, modify CAS 409 to be consistent with IRS rules).

LITERATURE ABSTRACT

TITLE: "A Briefing on DOD Profit Policy Revisions Set for January Implementation"

AUTHOR: Grady L. Jacobs

PUBLICATION: NCMA Contract Management Magazine, Issue 1, Volume 20, January 1980

OVERVIEW: The article reviews the anticipated effect of two significant changes to DOD profit policy: (a) an increase in the importance of facilities capital employed as a profit determinant, and (b) the introduction of separate weighted guidelines for the determination of profit on non-capital intensive R&D and services contracts.

MAJOR FINDINGS/POINTS: There are four problems with current profit policy.

1. The present emphasis on facilities capital employed provides inadequate motivation for contractor investment.

2. Better guidance is needed on use of the cost risk factor.

3. Weighted guidelines as presently configured are inappropriate for non-capital intensive contracts.

4. The relationships between R&D and service contract profit levels is distorted.

As a matter of DOD policy, R&D contracts should provide more profit than service contracts. At the time the article was written, the reverse was true.

The changes in weightings for cost risk in relation to contract type are not new, but reflect a reversion back to DOD policy prior to Profit '76.

The observation is made that both industry and DAR Council comments have or will be obtained before the proposed changes are implemented.

LITERATURE ABSTRACT

TITLE: "Determination of the Affects of DPC 76-3 on the Performance of Air Force Contracts"

AUTHOR: Harry R. Kain

PUBLICATION: Contracted report by Advanced Management Systems, Incorporated, McLean, Virginia, 31 May 1978.

OVERVIEW: In order to determine the effect of DPC 76-3 on the performance of Air Force Contracts, AMS interviewed management personnel from 22 firms that AFSC requested be included in the study. A basic finding of the study was the DPC 76-3 (Profit '76) had minimal impact on the investment plans, policies, and actions of the surveyed contractors.

MAJOR FINDINGS/POINTS:

1. All respondents stated that DPC 76-3 had a negligible impact on their investment decisions.

2. The financial criteria used by the contractors in reaching their investment decisions were profit, ROI, discounted cash flow, and payback period.

3. Factors such as high unemployment, high energy costs, and extreme currency fluctuations were cited as factors contributing to the overall capital investment lag.

4. The effect of inflation is pervasive. It distorts virtually all the financial yardsticks by which businessmen measure performance. Many companies, while showing an accounting profit, have in effect been "losing money" when taxes, and the replacement values of inventories and plant and equipment are fully considered.

CONCLUSIONS:

1. In our lagging economy where investments superior to the defense industry exist, it is not surprising to find that DPC 76-3 has had limited effect on contractor investment plans.

2. The risk of defense business must be reduced to that of competitive investment alternatives and the profitability of defense business must be made to match that of commercial business.

3. Defense oriented divisions of large conglomerates that compete with sister divisions in more profitable commercial lines have difficulty attracting their fair share of capital investment resources.

4. Depreciation reserves are not nearly sufficient to fund current sophisticated capital equipment requirements.

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LITERATURE ABSTRACT

TITLE: "Federal Procurement Policy and Profit Theory"

AUTHOR: Edward M. Kaitz

PUBLICATION: Copyrighted Booklet by Edward M. Kaitz & Associates, Inc., Washington DC (1979)

OVERVIEW: The national interest requires that the defense industrial base remain viable. Federal procurement policy, therefore, must keep defense profits from dropping to an unattractively low level.

MAJOR FINDINGS/POINTS:

1. Capital investment follows profit expectations. If defense profits are low, the incentive to invest in the defense sector will be correspondingly low.

2. If the Government wants funds invested in facilities, it must be prepared to provide the requisite cash flow.

3. A combination of tax, depreciation, and profit policy may be the most effective means of stimulating increased facilities capital expenditures.

4. For utilities, profit limitations are based upon replacement value of assets employed. Could defense profits be similarly based, with an additional allowance for stockholder dividends?

5. Maybe defense contractors should be treated more like utility companies--that is, guarantee them the profits they need to modernize as we wish them to.

6. During World War II, firms engaged in defense production were granted special write-off privileges for plant and equipment. In this manner the burden of inducing capital investment was removed from the negotiation process and paid for out of general funds.

CONCLUSIONS:

1. National interests are not served by squeezing essential industrial firms dry, but this is the result of current DOD profit policy.

2. Framers of DOD profit policy must be broad enough in their thinking to consider the national interest and to depart from conventional wisdom if necessary.

LITERATURE ABSTRACT

TITLE: "A Uniform Profit Policy for Government Acquisition"

AUTHOR: Logistics Management Institute

PUBLICATION: Contracted Report Dated December 1978, Prepared by LMI for OFPP

OVERVIEW: The purpose of the study was to develop a uniform government-wide policy for determining equitable prenegotiation profit objectives. The uniform policy developed and recommended by LMI has two formulas: for service contracts, a profit formula based on cost; for manufacturing and construction contracts, a hybrid profit formula based on cost and capital.

MAJOR FINDINGS/POINTS:

1. A cost-based profit structure discourages investment in labor saving capital facilities.

2. A cost-based profit policy discourages the participation of capital intensive firms in government work.

3. The virtues of a cost based structure are its ease of application and its ability to cope with inflation.

4. The objective of the study was to create a profit policy that would provide the contractor with an opportunity to earn a commercial equivalent rate of return for work of similar capital requirements, risk, and complexity.

5. The recommended cost-based profit formula and the hybrid profit formula are presented.

6. The hybrid formula for establishing prenegotiation profit objectives is similar to the method used by the British Government.

CONCLUSION:

The recommended hybrid profit policy encourages investment by offering the opportunity to earn commercial equivalent profit rates, by explicitly recognizing and rewarding facilities capital, by including the sharing of cost savings on cost type contracts where appropriate, and by encouraging the participation of efficient capital intensive firms.

LITERATURE ABSTRACT

TITLE: "Profit Negotiations and Promotion of Contractor Efficiency"

AUTHOR: Robert W. Nick and Gerald A. Klopp

PUBLICATION: Study APRO 80-08 by U.S. Army Procurement Research Office, U.S. Army Logistics Management Center, Fort Lee, Virginia (undated, but study was completed after 10 October 1980).

OVERVIEW: The objective of this study was to measure the negotiated ranges of profit rates on on noncompetitive production acquisitions. Based upon this information, the second objective was to identify a means of using profit as a motivator for contractor efficiency.

MAJOR FINDINGS/POINTS:

1. There seems to be a "profit ceiling philosophy" existing throughout the DOD which precludes wide ranges of negotiated profit. The report contains statistics on ranges of profit levels negotiated by DARCOM in Fiscal Years 1974 through 1979 on some 450 noncompetitive FFP and FPIF contracts. Contrary to the stated findings, it appears that a fairly wide range of profit rates was negotiated for the studied contracts. There is, however, a strong indication of some sort of a mental barrier against exceeding a 15% relationship of profit to cost.

2. Fairly steady annual increases in profit rates were noted in all three studied categories: proposed, government objective, and negotiated.

CONCLUSIONS:

1. Proposed and negotiated profit rates have shifted upward but the range of rates has not changed significantly.

2. The elimination of narrow ranges will not of itself bring about contractor efficiencies. Only negotiated profit rates that are tied to efficiencies effected by the contractor will truly encourage efficiency.

LITERATURE ABSTRACT

TITLE: "Misconceptions of Profit in Defense Policy"

AUTHOR: G. R. Simonson

PUBLICATION: National Contract Management Journal, Winter 1982, Vol 15, Issue 2

OVERVIEW: Article discusses misleading views that form basis of government's profit study. Because of certain misconceptions, DOD did not enact a policy which required that negotiated profits be based primarily on capital value employed by defense contractors for purpose of inducing greater investment in defense production.

MAJOR FINDINGS/POINTS:

1. High ROI in defense industry is not due to large profits (numerator) but rather low investment (denominator).

2. Investment is low because the true ROI is less than obtainable in commercial market. Only 17 percent of weighted guidelines (WGL) profit is for facilities capital usage; the other 83 percent is based on production costs. This 17 percent plus CAS 414 cost of money on facilities capital is the true return for capital use and not total profit as maintained by DOD. As long as defense profit policy does not recognize this, defense related investment will not change.

3. Facilities capital is only 78 percent of net worth (basis for computing ROI). Therefore, because total net worth is not considered in profit policy, the ROI computed through WGL is overstated by 22 percent. Industry should be paid on basis of total capital used, not just facilities capital used.

4. Increasing profit rate on sales to be comparable with commercial sector will not increase capital investment. Profit on sales has no direct relationship with ROI. This is a major flaw in Profit '76 study.

5. Basing profit on cost is a mistake because it encourages contractors to increase production costs and discourages capital investment which might reduce costs.

RECOMMENDATION:

Profit should be completely based on estimated value of total equity capital employed on negotiated defense contract and set at a rate higher than obtainable in commercial sector.

LITERATURE ABSTRACT

TITLE: "GAO Review of Profit '76"

AUTHOR: Elmer R. Staats, Comptroller General of the United States

PUBLICATION: Letter to the Secretary of Defense re GAO Report B-159896; PSAD-77-75; 17 Feb 77

OVERVIEW: GAO found the approach used by the "Profit '76" team to be generally competent and professional. However, GAO expressed concern as to whether the aim of increased contractor investment in capital equipment would accually be achieved.

MAJOR FINDINGS/POINTS:

1. The commercial centers selected by defense contractors for comparison purposes could have been slanted.

2. Before tax returns on sales and total assets for the period 1970 through 1974 were:

	DEFENSE CONTRACTORS		DURABLE GOODS MANUFACTURERS
	GOVERNMENT PROFIT CENTERS	COMMERCIAL PROFIT CENTERS	
SALES	4.7% on $12.9B	17.1% on $8.5B	6.7% on $450B
TOTAL ASSETS	13.5%	17.6%	10.7%

It was on the basis of the difference between the 13.5% and the 10.7% return statistics that the "Profit '76" team determined increased profit on government business could not be justified.

4. Offsetting facility capital cost of money (FCCM) in profit, based on the assumption that Weighted Guidelines (WGL) implicitly include an amount to satisfy the cost of money is correct.

5. The incentive to invest provided by the capital investment feature in WGL is too small.

6. Adding the special productivity factor was a good idea, but implementing instructions are weak. They should include a definition of what constitutes productivity gains.

RECOMMENDATIONS:

1. Closely monitor implementation of the new profit policy.

2. Check later on to see if the .3 offset in WGL for FCCM is appropriate.

3. Reduce weighting for cost in WGL.

4. Provide additional guidance on use of the special productivity factor in WGL.

LITERATURE ABSTRACT

TITLE: "Recent Changes in the Defense Department's Profit Policy - Intended Results Not Achieved"

AUTHOR: Elmer R. Staats, Comptroller General of the United States

PUBLICATION: Report to the Congress, 8 March 1979

OVERVIEW: The DOD expected that the policy changes made as a result of its profit study entitled "Profit '76" would encourage contractors to make substantial investments in cost-reducing facilities. However, cost-reducing investments have not been made primarily, according to GAO, because too much emphasis is still placed on estimated contract costs in establishing prenegotiation profit objectives.

MAJOR FINDINGS/POINTS:

1. There is little indication that contractors responded positively to DOD's attempt to encourage investment.

2. Reason for low investment is the limited emphasis given to facilities investment in establishing profit objectives.

3. Emphasis on capital investment should be substantially increased in weighted guidelines.

4. GAO blames increase in profit rates in first 18 months after "Profit '76" on the new profit policy.

5. GAO concluded that the .3 offset factor needs to be increased.

6. The new profit policy lacks sufficient definition criteria for determining appropriate profit allowances for productivity improvements.

RECOMMENDATIONS:

1. In establishing profit objectives, substantially increase emphasis on facilities capital investment and decrease the emphasis on CITP.

2. Prior to any contract negotiation, the return on facilities investment should be computed.

3. Perform an analysis to determine if there is a need to change the FCCM offset factor in WGL.

4. Establish more definitive guidelines for determining appropriate profit allowances for facilities capital employed, cost risk, and productivity improvements.

APPENDIX B

AFSC PROFIT STUDY '82

ACQUISITION PERSONNEL OPINION SURVEY

USAF SCN 82-46

JUNE - AUGUST 1982

ACQUISITION PERSONNEL OPINION SURVEY

PART I

The following questions were included in the Profit '76 procurement personnel opinion survey. They were also included in this survey to determine if there have been significant changes in opinion during the last seven years. Responses were indicated by using the scale shown below.

A - Strongly Disagree, B - Disagree, C - Neither Agree nor Disagree, D - Agree, E - Strongly Agree

	PROFIT '76*					AFSC '82				
	A	B	C	D	E	A	B	C	D	E
1. The DOD should substantially revise its profit policies.	3%	23%	20%	42%	11%	2%	17%	19%	41%	21%
2. The Weighted Guidelines (WGL) are used more as a crutch to justify the final negotiated price, rather than as a tool to develop an appropriate profit.	8	38	8	31	14	13	31	10	34	12
3. Most DOD personnel who negotiate profit or fee have a good understanding of WGL.	2	16	14	57	9	4	23	19	48	6
4. Increased profits to contractors will tend to result in decreased production costs.	17	39	23	17	2	16	37	20	23	4

*Responses reported in Profit '76 did not always total to 100%

ACQUISITION PERSONNEL OPINION SURVEY

	PROFIT '76					AFSC '82				
	A	B	C	D	E	A	B	C	D	E
5. Profits of defense contractors are too low.	5%	35%	32%	23%	3%	5%	29%	25%	36%	5%
6. The Weighted Guidelines tend to depress negotiated contractor profits.	10	46	17	24	1	7	33	19	35	6
7. There is little direct relationship between quality or performance of product and levels of profit.	5	32	11	42	8	4	30	12	42	12
8. The current Weighted Guidelines approach is sufficiently flexible to provide adequate profits to the majority of contractors.	2	21	7	63	4	3	37	13	41	6
9. Profit on defense business should be less than profit on commercial business.	9	40	18	26	4	12	41	13	27	7
10. The system puts much pressure on contracting officers to keep profits down.	4	22	13	45	14	3	24	15	43	15
11. Profit should be allowed on escalation under economic price adjustment clauses.	19	38	9	29	3	25	33	13	25	4

		PROFIT '76					AFSC '82				
		A	B	C	D	E	A	B	C	D	E
12.	Regardless of WGL, contractors are out for a specific profit return on each item.	2%	13%	9%	57%	18%	2%	8%	10%	55%	25%
13.	Contractor capital investment should be more significantly rewarded under the Weighted Guidelines.	1	12	25	51	9	9	19	18	37	17
14.	No matter how acceptable a contractor's initial proposal, in practice, government efforts are made to negotiate the price downward.	10	33	8	43	5	4	27	8	42	19
15.	In negotiating contracts, the potential impact of that contract on total company business and sales is usually taken into consideration.	2	21	9	63	2	7	32	13	46	2
16.	There has been a significant decline in the number of competitive contractors.	1	21	26	44	7	1	19	32	38	10

ACQUISITION PERSONNEL OPINION SURVEY

PART II

As a result of Profit '76, there were major changes to the DOD profit policy which were designed to encourage greater contractor investment in productivity enhancing capital facilities and equipment (DPC 76-3). The most significant changes were as follows: (1) imputed cost of capital for facilities investment (CAS 414) was to be recognized as an element of cost and not profit, (2) WGL were restructured to reduce importance of contractor effort and increase importance of risk and facilities investment, and (3) the special productivity factor was introduced. In 1979, DOD concluded that further revisions were needed (DPC 76-23). The most significant changes were as follows: facilities investment weightings were increased from 6-10 percent to 16-20 percent, (2) cost risk factors were reduced for CPFF and incentive contracts containing only cost incentives, and (3) separate WGL were created for manufacturing, research and development, and service contracts.

The following questions survey opinions on specific portions of today's profit policy. Response indicated by using scale shown below.

A - Strongly Disagree, B - Disagree, C - Neither Agree nor Disagree, D - Agree, E - Strongly Agree

	AFSC '82				
	A	B	C	D	E
17. The profit policy revisions in DPC 76-3 Profit '76) have resulted in increased investment.	7%	44%	34%	14%	1%
18. The profit policy revisions in DPC 76-23 policy) have resulted in increased capital investment.	6	41	35	16	2

		AFSC '82				
		A	B	C	D	E
19.	Profit policy can be an effective tool for encouraging contractor investment in plant and equipment.	3%	15%	14%	58%	10%
20.	Profit policy inducements to invest in capital assets can be effective only if combined with other inducements.	1	9	17	58	15
21.	The best way to induce contractor investment in capital assets is to change the relative importance of profit factors within WGL.	5	42	31	19	3
22.	The best way to induce contractor investment in capital assets is to increase the overall profitability of defense work.	3	18	12	53	14
23.	The weighted guidelines format should be simplified.	0	18	31	38	13
24.	Proper use of the Mfg, R&D, and Services columns in WGL is confusing.	1	31	16	39	13
25.	There should be only two columns in WGL--one for capital intensive contracts, and one for non-capital intensive contracts.	1	17	38	36	8
26.	The method for offsetting facilities capital cost of money needs to be simplified.	1	8	24	51	16

	AFSC '82				
	A	B	C	D	E
27. Facilities capital cost of money should be included in the cost base for determining profit.	12%	31%	19%	35%	3%
28. Using cost as a measurement base, yields a realistic reward for contractor effort.	9	35	20	35	1
29. The cost-based method of determining profit discourages cost reductions.	1	25	18	40	16
30. Contractors experience less risk in today's defense contracting environment than five years ago.	14	41	18	22	5
31. The capital employed factor is too small to provide a tangible incentive for investment.	2	19	27	48	4
32. Capital employed should be based on future asset acquisitions rather than capital assets already owned by contractor.	6	25	22	37	10
33. Capital employed should be based on replacement costs of capital assets not historical cost.	5	21	19	51	4
34. Return on investment (ROI) should be the major determinant of profit.	2	27	18	39	14
35. An ROI method is not administratively practical.	4	29	37	26	4

		AFSC '82				
		A	B	C	D	E
36.	The special productivity factor (line 19 in WGL) is a viable tool for encouraging and rewarding productivity improvements.	8%	34%	31%	26%	1%
37.	The special productivity factor is administratively too difficult to apply.	1	22	34	37	6
38.	The Government profit/fee objective is often dictated by management, regardless of the WGL computation.	7	20	12	47	14
39.	Increased capital investment by defense contractors will produce cost reductions.	1	14	26	41	18
40.	Defense contractors are adequately compensated for interest expense on net investment (total work in-process investment less progress payments).	10	37	31	18	4

ACQUISITION PERSONNEL OPINION SURVEY

SUMMARY OF RESPONSES

Area of Expertise	ASD	ESD	SD	AD	AFCMD	OTHER	TOTAL
Contracting Officer	18	6	5	3	43	17	92
Price Analyst	21	8	6	3	11	9	58
Other	1	3	1	0	10	5	20
Total	40	17	12	6	64	31	170